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TAX PLANNING AND
Business management
EDITED BY CHARLES S. LOWRIMORE, Sr., CPA

IRS continuing attack on insured redemptions despite court setbacks; Sanders reversed

by **ROBERT J. LAWTHERS**

With the reversal by the Tenth Circuit in Sanders v. Fox, the Government has lost on appeal the third of the three cases in which it was successful in the lower court in taxing stockholders on the premiums paid by their corporations on life insurance on their lives. Yet an analysis of shifting position taken by the Government in its briefs in these appeals and a consideration of Holsey, an uninsured redemption case, indicate that the IRS is testing a wide range of theories which might support taxation of the stockholders of closely held corporations when they actually carry out their buyout plans, insured or not. Though Mr. Lawthers foresees ultimate victory for taxpayers, it is important that plans now in effect conform as closely as possible to the normal, routine, orthodox arrangement.

IN CASALE, and in fighting the battles on *Prunier* and *Sanders* in the trial courts, the Government seems to have been really attempting to get premium payments taxed as income to shareholders. However, there seems to have been some change in tactics following the *Casale* reversal.

In its brief on the *Prunier* appeal, the Government threw away whatever chance it may have had of winning the case by failing to make any attempt to controvert the taxpayers' argument that the corporation was the equitable owner of the policies. It concentrated on the benefit of stock redemptions to the shareholders of closely held corporations.

In the government brief on the *Sanders* appeal, we find, to some extent, a similar tactic, but with an added refinement. The Government concedes the benefits to the corporation of a stock-redemption agreement, and life insurance to implement such an agreement, but claims that these must be weighed against benefits to shareholders. It contends that the shareholders will be found to benefit more, and should therefore be taxed.

Before we analyze the position of the Government and the courts in these three cases involving premiums, let us look for a moment at *Holsey*,[1] not involving insurance premiums, in which the Tax Court unanimously found a 50% shareholder liable for income tax on the amount used by his corporation to redeem the other 50% of the outstanding stock. The Tax Court saw this as essentially the same as though the corporation had made funds available to the remaining shareholder for him personally to acquire the retiring shareholder's stock.

Is the government less concerned, perhaps, with winning the premium battle than with an attempt to tax shareholders at *some time* in connection with stock redemptions?

If the *Holsey* doctrine of the Tax Court should stand up, then, in closely held corporations, provisions for stock redemptions could result in income-tax liability for remaining shareholders at the time of redemption if there is no insurance, or insurance which has not previously been adequately insulated from the corporation, or could result in such liability at the time of premium payment if there is insurance which has really been insulated—apparently a difficult feat to achieve.

From *Golden*,[2] we know that, if a corporation pays premiums on life insurance of which it is not the beneficiary, the payment by the insurance company to the beneficiaries at the death of the insured can be deemed the distribution of a taxable dividend by the corporation —if the corporation has reserved a sufficiently substantial interest in the policy to be extinguished at death. Under such circumstances, the premiums, as paid, will not be taxable.

From *Doran*,[3] we know that such a payment of insurance proceeds, created by corporation-paid premiums, cannot constitute such a distribution if the corporation has not retained an interest to be extinguished at death and it is not a conduit at the death of the insured. In such event, if anything is taxable, it must be the premiums as paid.

From *Bonwit*,[4] we know that the payment of an insurance premium can represent a taxable distribution by a corporation if at death the proceeds of the insurance are to be paid other than for its benefit, and it has not reserved rights through which it may prevent such payments of the proceeds—even though the taxpayer deemed to receive the distribution does not possess the right to change beneficiaries, to surrender the policy or to exercise other policy rights.

At the present stage of development, both *Prunier* and *Sanders* could represent mere skirmishes, lost by the Government without too much pain so far as the taxability of premiums is concerned —part of the war represented by *Holsey*, but secondary to an attempt to establish *its* general principle. If, before death had occurred, the Government had fought the premium battle on *Doran, and had lost*, the ammunition needed by the Government for the winning of the tax on the insurance proceeds at death might have been furnished by the taxpayers' victory on the premiums, and their arguments used to achieve it.

If *Holsey* should stand up, and other similar cases which would then follow, with, perhaps, the refined technique of the *Sanders* brief respecting the weigh-

[1] Joseph R. Holsey et ux., 28 TC No. 107 (8/8/57), on appeal CA-3. See Springer, "New Tax Court Policy," 7 JTAX 269 (Nov. 1957).
[2] Golden v. Commissioner, 113 F.2d 590 (CA-3, 1940), *aff'g* 39 BTA 676. See Lawthers, "Life-Insurance Proceeds Subject to Income Tax," C.L.U. Journal, Vol. XI, No. 1, p. 44 (Winter, 1956).
[3] Doran et al v. Commissioner, 246 F.2d 934 (CA-9, 7/9/57), *rev'g* TC Memo, P-H 56,121, CCH 21,738. See Lawthers, *op. cit.* note 2.

ing of the benefits, the taxpayers involved in *Prunier* and *Sanders* could look forward to income-tax liability when stock is redeemed at a death.

The premium cases; Casale

As you will recall, *Casale* (26 TC No. 1020, *Rev'd. Unan.* 247 F.2d 440) involved a deferred-compensation agreement between an employed 98% shareholder and his corporation, and insurance on his life paid for by the corporation. The insurance policy provided solely for the corporation as beneficiary, endowment payee and owner. The policy was not referred to in the deferred-compensation agreement, and was not in any way set aside to be devoted to fulfilling the agreement. Nevertheless, the Tax Court, in a unanimous decision, found that premiums paid by the corporation were taxable income to the insured on a pseudo alter ego theory.[5]

But the Second Circuit, in its unanimous reversal, reaffirmed the realities of the law. A corporation actively engaged in business is not a sham for tax purposes. An asset owned, without restriction, by such a corporation cannot be attributed to a shareholder, even though the asset be a life-insurance policy. So long as the policy and its proceeds will be available to creditors of the corporation in the event of insolvency, any interest of the insured is at the most tentative, and he cannot be currently taxed.[6]

Prunier

Prunier (28 TC No. 19, *Rev'd. Unan.* 248 F.2d. 818) involved payment of premiums by a corporation on insurance policies on the lives of two brothers who together owned all (later, almost all) of its stock. The policies, according to their terms, were solely for the benefit of these individuals. However, there were ineptly worded entries on the corporate minute books which could be construed as requiring the use of the policies and their proceeds to effect a redemption by the corporation of the insured's stock at his death. With three judges dissenting, the Tax Court found taxable income to the brothers with each premium payment.

The First Circuit unanimously reversed, on the ground that under Massachusetts law the corporation was the equitable owner of the policies, and thus there could be no tax to the shareholders with each premium payment—expressly leaving open the question of tax liability at the death of an insured. However, there are dicta respecting the limited utility of attempting to distinguish between corporate purposes and shareholder purposes, in acts of closely held corporations, and respecting the benefits to such corporations of stock redemptions and agreements to effect them. From these it seems unlikely that the First Circuit would go along with any broad, generally applicable doctrine that remaining shareholders benefit from such redemptions to such an extent that they should be taxed.[8]

Sanders—the facts

Sanders (149 F. Supp. 942) is, in many ways, the most interesting case of the three. A corporation entered into a stock-redemption agreement with its four employed shareholders, a husband and wife, who, together, owned a majority of the stock, and a son and another employee, who owned equal minority interests. The corporation paid premiums on insurance on each life. Each policy named such death beneficiary as the insured had specified, but provided that during the life of the insured every incident of ownership should be exercisable by the corporation. By the stock-redemption agreement, the corporation agreed to pay premiums from earnings or surplus which would otherwise be available for distribution as dividends, to set the policies aside as a special reserve to carry out the agreement, and to name such death beneficiary therein, from time to time, as the insured might desire.

The price to be paid by the corporation for the stock of a deceased shareholder was to be determined, from time to time, from a value assigned to all stock of the corporation by a unanimous vote passed at a duly called stockholders' meeting. It was expressly provided that this value was not to include any value on account of the insurance policies carried pursuant to the agreement. The price of a decedent's stock was to be the proportionate part of the value so arrived at (corresponding to his proportion of stock ownership) plus the same proportionate part of the cash surrender value of all policies carried pursuant to the agreement, including those on the decedent's life. If, however, the proceeds of such insurance on the deceased shareholder's life should be in excess of the price that would otherwise be determined, the insurance proceeds would then be the minimum purchase price.

Payment by the insurance company to the beneficiaries named in the policies on the decedent's life was to be deemed a payment by the corporation for the stock of the decedent; or if the insurance proceeds should be less than the price to be paid for all of the stock, for as much of the stock as could be purchased with the insurance proceeds. In the latter event, the corporation would have an option to purchase remaining stock with earnings or surplus.

If at any time the corporation should not have earnings or surplus available for a premium payment, the agreement would terminate, the death beneficiary of all policies would be changed to the corporation, and the policies would be available for any general corporate use.

If a shareholder should desire, during life, to sell his stock, he would be required first to offer it to the corporation. If the corporation should elect to purchase the stock, the agreement would continue among the remaining shareholders. The corporation would have the option of permitting the retiring shareholder to buy the policies on his life for their cash values, or of changing the beneficiary of such policies to itself, with itself as sole owner free from the terms of the agreement. If, under such circumstances, the corporation should decline to purchase the offered stock, and the shareholder should sell to anyone else, the agreement would automatically terminate in its entirety, and the beneficiary of policies *on all lives* would be changed to the corporation.

Sanders—the district court's opinion

The trial Court upheld the Commissioner in finding the shareholders, respectively, liable for tax on the aggregate premiums on all policies paid by the corporation each year, in proportion to their shareholdings.[9] The judge seems to have seen the benefits from premium payment as flowing equally to the corporation and the shareholders,

[4] Commissioner v. Bonwit, 87 F.2d 764 (CA-2, 1937), *aff'g* in part and *rev'g* in part *Paul J. Bonwit*, 33 BTA 507, *cert. den.* 302 U.S. 694. See Lawthers, *infra* note 17.
[5] See Lawthers, "Weakness in *Casale* decision," 5 JTAX 342 (Dec. 1956).
[6] See: Jones and Gleason, "Casale Reversed," 7 JTAX 258 (Nov., 1957); and Lawthers, "Life Insurance Carried by a Corporation," The Practical Lawyer, Vol. 3, No. 7, p. 70 (Nov., 1957).
[7] See: Mannheimer and Friedman, "Stock-Retirement Agreements—The *Prunier* and *Sanders* Cases," 35 TAXES 567 (August, 1957); and Lawthers, "Prunier offers no threat to a sound insured buyout plan," 7 JTAX 2 (July, 1957).
[8] See Lawthers, "Prunier reversed," 8 JTAX 12 (Jan., 1958).
[9] See Mannheimer and Friedman, *op. cit.* note 7.
[10] Paramount-Richards Theatres, Inc., et al. v. Commissioner, 153 F.2d 602 (CA-5, 1946), *aff'g* TCM, P-H 44,274, CCH 14,085.
[11] 176 F.2d 646 (CA-1, 1949).

[*Robert J. Lawthers is Director of Estate Planning Services of the New England Mutual Life Insurance Company in Boston.*]

except that he did see one benefit flowing solely to the corporation, namely, its being assured of keeping its stock intact.

With respect to benefits flowing to shareholders, there is a lack of discrimination between benefits seen as flowing to an insured shareholder (such as his being assured of a fair market price for his stock at death, and the possible fixing of the value of his stock for estate-tax purposes) and benefits which would flow to shareholders other than the insured (such as the enhancement of their proportionate interests in the capital and surplus of the corporation after a redemption had been effected)—incidentally, neither of which could have properly produced exactly the proportionate allocation of taxable income among the shareholders that the Commissioner had determined.

The court seems to have been confused by the provision for payment of a proportionate part of the cash values of policies in addition to the payment of the proportionate part of the otherwise determined "fair value." The trial judge seems to have believed that this meant that a shareholder would receive more than the fair value—ignoring the fact that such value was to have been established without reference to the value of the insurance policies. He also appears to have been influenced by the fact that the insurance proceeds would constitute the minimum payment for a deceased insured's stock even if the stock should become of little value.

Economic benefit

The theory, in this opinion, that if shareholders of a corporation and the corporation itself benefit equally from some expenditure by the corporation, the shareholders may be taxed on the expenditure under some economic-benefit doctrine, is a novel one. An analogy, obscure to me, was seen to *Paramount-Richards*,[10] in which it was held that when a corporation makes an expenditure which does not benefit itself but equally benefits its two shareholders, the amount expended may be taxed equally to the two shareholders.

On the precedent of the Tax Court's *Casale*, and likewise on a pseudo alter ego theory, the court ignored the problem of timing, and viewed the economic benefit to the shareholders as furnished at the time of premium payment.

Sanders—the taxpayers' brief

The taxpayers' brief, on the appeal, made the best of the taxpayers' case.

It minimized the extent to which the policies and their proceeds had been insulated from general corporate use. It referred to the corporation as the owner of the policies, as though the agreement setting them aside as a special reserve had not been executed, or could not possibly have current tax results even if absolute.

It, quite properly, emphasized the conditions under which the policies, or some of them, might be freed from the restrictions of the agreement, and thus the impossibility of determining whether, and under what circumstances, what shareholders, if any, would benefit from a premium payment.

It took full advantage of the extent to which the trial judge had relied on the Tax Court's *Casale*, with its improper considering of the corporation as the alter ego of its shareholder, and of the very different climate in the light of the reversal of *Casale* by the Second Circuit.

It denied the benefits which the trial judge had seen as flowing to either an insured shareholder, or the other shareholders, from the agreement, both at the time of premium payment and at the time of a redemption. It particularly denied that taxable income could be realized by remaining shareholders by reason of the redemption by a corporation of another shareholder's stock.

With respect to this last, it made the most of the First Circuit's reversal of *Prunier*, and its earlier *Lewis v. Commissioner*[11] in which that Circuit had questioned the practicality of attempts to distinguish between corporate purposes and stockholder purposes.

It denied the applicability of *Paramount-Richards* to the instant facts.

It emphasized the benefits to be derived by a closely held corporation from a stock redemption, an agreement to effect such a redemption, and life insurance to implement such an agreement, citing the Third Circuit's *Emeloid*.[12]

Sanders—the Government's brief

The Government concentrated on two points: the degree of insulation of the policies from general corporate use; and what it saw as the weight of benefits as between the shareholders and the corporation.

It viewed the circumstances as falling between keyman insurance carried by a corporation for general corporate purposes and insurance carried by a corporation with the insured as owner and a third party as beneficiary. Under the circumstances, it claimed that there must be a weighing of the benefits. Ingeniously, it admitted a benefit to a closely held corporation from an agreement to redeem its stock, and insurance to implement such an agreement, but it claimed that the principal benefits were to the shareholders.

It distinguished from the Second Circuit's *Casale* on the ground that in that case the corporation was the sole, unrestricted beneficiary and owner of the policy, whereas in *Sanders* the corporation was not the beneficiary, and had, by agreement, restricted its rights to deal with the policies.

With respect to *Emeloid*, it called attention to the fact that during the taxable year in question in that case, the insurance was carried solely as keyman insurance, and that the statements of the court respecting corporate purposes of stock-redemption agreements were only dicta. Furthermore, it took the tack that *Emeloid* and *Prunier* could be distinguished because, in deciding them, the courts had been concerned merely to find *some* corporate purpose, and that the courts had not had the opportunity to consider the benefits also derived by shareholders and to weigh the two against each other.

Aside from the foregoing, the Government brief was, in the main, of the picking-flyspecks-out-of-pepper type.

The Sanders reversal[13]

The majority opinion of the Tenth Circuit is principally on the matter of timing. The mere entering into of an executory agreement between a corporation and its shareholders cannot result in taxable income to the shareholders.

Furthermore, the majority does not appear to have been impressed by the government's weighing - of - the - benefits

[12] The Emeloid Co., Inc. v. Commissioner, 189 F.2d 230 (CA-3, 1951), *rev'g* 14 TC 1295.

[13] March Term, 1958, Nos. 5718, 5719 and 5720. Majority opinion written by Lewis, Circuit Judge; Murrah, Circuit Judge, dissenting.

[14] The court cites the First Circuit's Prunier v. Commissioner and Lewis v. Commissioner.

[15] The court is quoting from Lewis v. O'Malley, 140 F.2d 735 (CA-8, 1944), rev'g 49 F. Supp. 173.

[16] See Jones and Gleason, *op. cit.* note 6; and Lawthers, *op. cit.* note 7 and *infra* note 17.

[17] For my detailed recommendations, see Lawthers, "The Fragile Bark of the Small Corporation," C.L.U. Journal, Vol. XII, No. 1, p. 4 (Winter, 1957).

argument. "Because of the interlocking benefits contemplated by such an agreement . . . the test of weighing the ultimate purposes to be served and the potential benefits, as has been done by some courts and as was done by the trial court in this case, is impractical.[14] . . . 'In income taxation, no matter what form the transactions may take, the inquiry must always go to the fundamental, whether the taxpayer really had income . . .' "[15]

". . . The simple execution of such a contract would give rise to no taxable event. . . . It is true that because the stockholder is guaranteed a minimum sales price for the stock, the stockholder may ultimately benefit considerably from the policy and agreement, but the amount of gain, if any, can only be evaluated at that time. During the contemplated life of the policy, the only realizable value, the benefits accruing to the owner of the policy, is with the corporation."

If premiums were to be taxed to an insured shareholder, he would be subject to tax at ordinary rates on the sale of capital assets, contrary to the purpose of the Sixteenth Amendment. Whether the taxpayer will profit from the method used must remain a matter of conjecture until the buyout agreement with him terminates. ". . . [W]hether the sale will in fact effect a dividend distribution must await the occurrence of his death."

Whether or not the possibility of future sale of a policy to an insured, under certain circumstances, for its cash value, will effect a dividend distribution to him, must also await the occurrence of the event.

"The immediate present benefits to the stockholder arising from the execution of the agreement, such as the assurance of a market at a guaranteed minimum return on his stock, the appreciation of the value of his stock, and the retention of corporate officers acceptable to his limited group, are not taxable incidents. Whatever taxable benefits he may receive from this agreement and policy are contingent upon future happenings and incapable of present determination. The immediate benefits of the investment redound to the corporation.

Under such circumstances it is not proper to impress premiums presently being paid with the label of constructive dividends. Upon the death or withdrawal of a stockholder, tax complications including the possibility of an assessment of constructive dividends may arise, but the solution of these dimly-foreseen and nebulous problems must await a clearer view."

Evaluation

Thus, while the *Sanders* reversal, along with the reversals of *Casale* and *Prunier*, gives us assurance that premiums will not be taxable income to the stockholders if, by the terms of the policies and all agreements and corporate minutes referring to them and the corporation's statement, it is clear that the policies are corporate property, the language of the *Sanders* opinion is a warning to the Government to litigate the taxability of the stockholders at another, and far more vital, point in the life of the buyout agreement—the time of the redemption of the stock. Owners of close corporations and their advisers face an extremely difficult decision—are the undoubted advantages of a compulsory buyout or redemption agreement greater than the tax hazard of a dividend tax at redemption?

Holsey or not, cautious practitioners will not, in my opinion, be inclined to follow the pattern of the agreement used in *Sanders* or of the policy provisions there described. A victory won only after going through two courts, and then only on a split decision, does not appear to furnish the most reliable basis for future safe action.

On the other hand, there seems to be no need to fear income-tax liability of shareholders for premium payments by a corporation, despite the use to which it is expected that policy proceeds will be put, if by the terms of the policies, and any agreement referring to them: the corporation is free to deal with the policies as it may wish; the proceeds at death will be available to meet claims of corporation creditors if needed for that purpose; and other modest and sensible precautions are taken.[16]

However, the matter of tax liability at the time of an actual stock redemption is a different problem. *Holsey* is on appeal to the Third Circuit, the circuit of *Emeloid*, which has given so much comfort respecting corporate purposes in stock-redemption agreements and insurance to implement them. Many of us have been inclined to assume that the Government would have no card to play in the taxpayer's appeal of *Holsey* to that circuit. However, the brief on the *Sanders* appeal may indicate that the Government does have a card of which we have seen a glimpse but the value of which is yet to be finally determined. If the Third Circuit should be inclined to affirm the Tax Court's *Holsey*, it may do so with knowledge that what it said in *Emeloid* was only dicta, and that it had not then had the opportunity to consider the benefits to the shareholders and to find them to be greater than even the so eloquently expressed benefits to the corporation.

I cannot, however, conceive of such a disaster.

An accepted doctrine that acts of a corporation are to be weighed to determine the comparative benefits to the corporation and to its shareholders, with different tax results depending on how the balance falls to rest, could not be confined to stock redemptions. Of necessity it would have to apply to every corporate act. The result would be nothing less than a complete breakdown of the whole scheme of taxing a corporation and its shareholders as separate entities.

So, in effect, said the First Circuit in its *Prunier* reversal, citing its earlier *Lewis v. Commissioner*.

Conclusion

Looking through form to substance, the weighing-of-the-benefits argument represents merely a more sophisticated form of the improper attempt to apply the alter-ego theory which we find in the Tax Court's *Casale* and the district court's *Sanders*. The Second Circuit, in its reversal of the former, has repudiated the straightforward attempt at this, and the Tenth Circuit, in its reversal of the latter, has shown as little hospitality for the more sophisticated version.

Accordingly, I do not anticipate that the Third Circuit will accept the opportunity that the Government may be expected to proffer it. I believe that Mr. Holsey has a right to be optimistic.

But when will the Government give up?

Until it gives up, it seems likely that the cases it will be willing to litigate will involve corporations controlled by one individual or a family, or those involving unusual procedures or circumstances. In the meantime, it may be unwise to have binding agreements for redemption of stock by corporations so controlled, or to depart from conservative, orthodox arrangements in such agreements for other corporations.[17]

In the event that the Third Circuit should affirm the Tax Court's *Holsey*,

or that the doctrine of that decision, or the weighing-of-the-benefits doctrine of the Government brief on the *Sanders* appeal, should achieve respectability in a different circuit, it may be necessary to reevaluate the whole matter.

I do not, however, expect this necessity to arise. ☆

New compensation decisions this month

Non-union SUB plan treated same as union plan. Provisions of *Rev. Rul.* 56-102 and 56-249 relating to the deduction of contributions made under a union-negotiated supplemental unemployment benefits plan and to income tax and withholding tax liability for the benefits paid under such a plan also apply to similar plans unilaterally instituted by the employer. *Rev. Rul.* 58-128.

New early-retirement rules don't apply to plans approved before 4/22/57. Part 5 of *Rev. Rul.* 57-163 changed the rule for early retirement from an employee profit, annuity, stock-bonus or pension plan. The new rule permits early retirement payments if the employer's consent is required only to the extent of the employee benefits vested at the time of retirement. The old rule required merely that no prohibited discrimination be likely. The IRS now holds that the new rule will not be applied retroactively to plans whose early retirement date provisions met the standards in effect before *Rev. Rul.* 57-163 and who had qualification letters issued prior to the publication of *Rev. Rul.* 57-163. *Rev. Rul.* 58-151.

Attorney is employee for back pay purposes. Taxpayer was the regional attorney and business manager of a coal mining corporation. He continued these duties when the company went into receivership in 1940 under an agreement that when the receivership was terminated, he would receive additional pay. The receivership was terminated in 1950 and taxpayer received $75,000. The court allows him to spread it back as back pay. This is not payment for professional services, but the wages of an employee. Taxpayer acted as the corporation's regional business manager, not in an independent professional capacity. *Howard*, DC Ky.

Payments during sabbatical for health are sick pay. Amounts which a public school teacher receives while on sabbatical leave for restoration of health may be excluded from gross income as "sick pay" provided the payments are received for a period which does not include the recipient's summer or other vacation time. *Rev. Rul.* 58-91.

Single sale of business not a trade. Taxpayer while serving as an officer of a company, arranged the sale of his employer corporation's stock to another corporation. For these services he received a commission. This was the only transaction of its kind that taxpayer ever engaged in. The IRS rules that this transaction does not constitute a business; taxpayer is not subject to the self-employment tax on the commission earned. *Rev. Rul.* 58-112.

Service defines "separation from service" for pension plan distributions. The Service has clarified its position as to when an employee is deemed to have "separated from the service of his employer" in cases of certain liquidations and reorganizations so as to make available to him capital gain treatment for a lump-sum distribution received from a qualified employees' trust. "Separation from the service" is held to occur in the following cases: (a) reorganization in which all the assets and liabilities of the employer are transferred to a corporation which then transfers the assets and liabilities to a wholly-owned subsidiary of the latter, and the employees of the predecessor became employees of the subsidiary, *Rev. Rul.* 58-94; (b) acquisition of all the employer's stock for cash by another corporation, followed by liquidation of the employer in a transaction amounting in substance to a purchase of assets for cash, and shortly thereafter the hiring of the employees by the acquiring corporation, *Rev. Rul.* 58-95; (c) sale of all the assets of a corporation (with resulting recognition of gain or loss) to a new corporation and the employees, at the time of sale, going over to the new corporation, *Rev. Rul.* 58-96; (d) incident to a plan of complete liquidation, a sale of assets used in carrying on the business of one of two divisions of a corporation to another corporation and the employees going over to the purchaser, *Rev. Rul.* 58-97; (e) liquidation of a corporation and formation of a successor-partnership by the former stockholder-employees to continue the business, *Rev. Rul.* 58-98. However, if the employees of a subsidiary are participants in a qualified plan established by the parent and the subsidiary is then separated from the control of the parent and continues as a separate entity, subsidiary employee-beneficiaries of the former parent's pension plan paid off in a lump sum are not considered as having been "separated from the service" and cannot report such payment as long-term capital gain. *Rev. Rul.* 58-99.

Employee plan was savings, not profit-sharing; no deduction for forfeitable contributions. Taxpayer set up an employee trust which in effect matched savings contributed by the employees. The court finds that scheme was not one of the statutory plans for which deduction is allowed; it was not a pension, annuity or stock bonus plan; it was not profit-sharing because matching would be required in the event of loss; and, since the employer's contributions were forfeitable under several contingencies, it cannot come under the general rule allowing deduction for non-forfeitable contributions. [This case involves 1950. A district court decision reported here last month, 8 JTAX 293, reached the same result in the same case for 1951 and 1952.—*Ed.*] *Mississippi River Fuel Corp.*, 29 TC No. 30.

Stock option income in year exercised [*Non-acquiescence*]. Taxpayer, an employee, received from his employer a non-assignable option to buy its stock at a bargain price. In December 1945, when the option was about to expire, he notified the employer of his election to exercise the option, but did not pay for or receive the stock until 1948. In determining whether taxpayer received compensation in 1945 or 1948, the court concludes that, when he exercised the option, the employee obligated himself to pay for and accept the stock unconditionally within a limited period of time. The acts of payment and transfer of title to the stock, occurring in a later taxable year, did not add to the economic benefit received. Accordingly the employee received compensation from the stock option in 1945. One judge dissents but files no opinion. *Ogsbury Estate*, 28 TC 93, *non-acq.* IRB 1958-13.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

How the courts distinguish deductible repairs from depreciable capital costs

by **JOHN B. COOK**

To accountants, the tests the courts use in distinguishing between repairs and capital items frequently appear confusing and contradictory. Although all the cases cannot be reconciled, there are enough carefully reasoned opinions to enable the investigator to deduce some general principles and draw up a useful guide. Mr. Cook, New York attorney and CPA, has done just this job and come up with an analysis which will be very helpful to the practicing tax man.

VIRTUALLY EVERY TAXPAYER using tangible property in his business must sooner or later face the problem of classifying an item as either a capital expenditure or a repair expense. This distinction between capital expenditures and current expense is more difficult to apply in practice than in theory because the line between betterment and improvements and repairs and maintenance is shadowy and indistinct. The difficulty of determining the capital or expense character of a particular item is magnified by the fact that any single item in certain cases may be classified as a capital expenditure, while in other circumstances such item may be considered expense.

Long ago in the railroad rate cases, the Supreme Court made it clear that expenditures for additions and betterments are properly chargeable to capital account and not against the revenues of a single day or year; however, expenses incurred in keeping the productive works in good condition and repair are chargeable to earnings. The Board of Tax Appeals adopted the Supreme Court's theoretical distinction in holding that expenditures for overhauling, enlargement, and improvement of taxpayer's plant are capital expenditures. The Board properly went on to hold that an expense of a permanent nature, such as putting a new roof on a building, constitutes a capital expenditure, while an item of temporary character and of frequent recurrence, such as repairing gutters on a building and decorating and painting, is current necessary expense. The soundness of these fundamental distinctions is self-evident. However, the Board at an early date recognized the difficulties that lie in the way of adopting a general rule to fit all fact-pictures. For the Board on other occasions has required capitalization of amounts spent for repairing rain water leaders and painting and repapering a building, but, on the other hand, also has permitted the expensing of a roof. Thus we see that a determination cannot be made of the capital or expense character of borderline "repair" items solely on the basis of a description of the work done.

It is impossible to reconcile all the opinions of the numerous cases in the repairs area. All too often insufficient facts are stated to make a thorough comparison. Each court in its best judgment has drawn the line on the available facts which are before it. Despite the superficial appearance of chaos in the repairs area, the vast majority of cases seem to be appropriately decided, since the question involves intensively practical judgment. Obviously, some single items considered by themselves are typical capital expenditures and others are typical expense items. The purpose of these comments, then, is to highlight the few major guideposts between the two extremes in the twilight area where repairs expense blends into capital expenditures. Indeed, so complete is this blending that ofttimes difficult items, of necessity, are compromised in the field by Internal Revenue agents or perhaps traded off against each other on the basis of their respective merits.

In reviewing the repair cases, it should be remembered that the question is one of fact: Are the expenditures, in essence, for replacements, alterations, improvements, or additions which appreciably prolong the life of the property, arrest deterioration, and increase the value and, accordingly, capital additions; or are the expenditures for the purpose of keeping the property in an ordinarily efficient operating, useful, or serviceable condition over its probable useful life and therefore allowable as current deductions? Having reviewed such facts as are available and having noted the relatively constant applicable rules of law, some courts are prompted to resolve the point with little comment other than on the difficulty of the issue. Precisely because of the difficult factual nature of the question, the decision of the Tax Court in a repairs case should not be disturbed on appeal unless manifestly wrong.

The Code contains no provision specifically authorizing the deduction of repairs as such. Thus repairs are deductible only if they qualify as ordinary and necessary business expenses. But, on the other hand, items are non-deductible capital expenditures if they are paid out for permanent improvements or betterments, made to increase the value of any property. The proposed regulations under the 1954 Code relating to repairs carry forward substantially the same meaning as that contained in the regulations for many years. Therefore we must turn to the opinions of the courts to observe how the necessarily general tests are applied in specific cases.

Expenditures extending life

According to the regulations, repairs in the nature of replacements are capital to the extent that they appreciably prolong the life of the property. The Code itself prohibits a deduction for amounts spent to restore property or in making good depreciation which has been deducted. Thus, as a starting point, we have the rule that, if life is prolonged or if depreciation is made good, the item is capital. But does not virtually every

repair increase the useful life of the property over what it would have been without the repair? And does not every repair tend to make good allowable past depreciation?

This basic definitional problem as to whether most repairs extend the life of the property was put to the court in the leading case on repairs, *Illinois Merchants Trust*, 4 BTA 103, where a sudden lowering of the water level caused the rotting away of the tops of piling which supported a seven-story brick building. The tops of the piling were sawed off below the water line and concrete supports were inserted. This involved removing a large portion of the ground floor as well as shoring up and raising the partially collapsed wall. The Commissioner contended that the work appreciably prolonged the life of the property and therefore denied the deduction on the ground that repairs in the nature of replacements should be capitalized to the extent that they arrest deterioration and appreciably prolong the life of the property.

The Board agreed that unquestionably the expenditure in issue prolonged the life of the building over what it would have been after the sudden lowering of the water level in the river. But since any repair, the Board said, increased the useful life of property over what it would have been without the repair, the Commissioner's contention would prohibit the deduction of any repair. The Board concluded that the life of the property which must be appreciably prolonged is the probable, normal, useful life for the purpose of the allowance for the return of the capital investment. The evidence was clear that the normal, useful expected life of this building was not increased, but indeed, it was shortened because the building was still ruptured and cracked even after the work was done. As regards life, the Board found on the record that the expenditure did not prolong the expected life of the property over what it was before the event occurred which made the repairs necessary. The deduction was allowed.

Fully depreciated property

Thus a physically identical replacement could be classified as a capital expenditure and not repair, if the building were fully depreciated. This is because a fully depreciated building has come to the end of its remaining useful life used to compute depreciation. The "repair" would enable continued use of the building over some new estimated remaining useful life which, of necessity, must extend the original exhausted life of the property used to compute depreciation. Where the new estimated remaining useful life extends appreciably beyond the termination of the old life, the capital sum expended should be recovered over the extended new period of life attributable to the expenditure.

If the property were fully depreciated, the deduction for repairs might properly be denied under the same general theory but under the different words of the Code provision which prohibits a deduction for any expenditure which restores property or makes good the exhaustion of the property for which an allowance has been made. For example, the court in another case relied on the statutory prohibition against a deduction for an expenditure which restores depreciated property and found that substantial repairs to the rotted woodwork of the stern of a barge amounted to a replacement. The court noted that the benefits of the expenditure were to last for several years, perhaps for the "remaining life of the barge." Under the test of *Illinois Merchants Trust*, just before the expenditure the barge was fully depreciated, and therefore the barge had no remaining useful life for depreciation purposes. It appears therefore that in the case of the barge, the court could equally well have said that, since the barge was fully depreciated, the expenditure was in the nature of a restoration which appreciably prolonged the life of the barge beyond the current year and therefore was not deductible as an ordinary and necessary business expense.

In summary, it might be said that the most important fundamental test which may determine the character of a repair is whether the repair appreciably extends the estimated remaining useful life of the property used to compute depreciation before the repairs were made. Or, stated with different emphasis, the concept of capitalizing expenditures which appreciably prolong the life of the property underlines the following relationship: the character of the repair must be considered in the light of the taxpayer's policy of assigning appropriate lives for depreciation purposes. In other words, the period over which the asset may reasonably be expected to be useful to the taxpayer may affect the treatment of the repair item. Furthermore, lives for depreciation purposes are influenced by the taxpayer's policy, not only as to repairs, but also as to renewals and replacements, as well as the particular conditions under which the property is used, all of which are reflected in the taxpayer's operating policy and accounting policy followed with respect to repairs and maintenance. This means, for example, that one taxpayer who, because of his operating and accounting policies, uses conservatively short lives, may incur a capital expenditure because the life used for depreciation purposes is extended by the repair. On the other hand, if the life used for depreciation purposes is longer and is not extended because of such different depreciation policy of the taxpayer, the identical item may perhaps be properly expensed as a repair.

Expenditures adding to value

The regulations negatively define incidental repairs which may be deducted as expense as not materially adding to the value of the asset being repaired. But most repairs which are made voluntarily do add to the value of the property, else why would they be made? On the other hand, circumstances beyond the control of the taxpayer may require substantial expenditures which clearly do not increase the market value of the property. Does this mean that solely with respect to the value test such items may be expensed?

We have the case, *Libby & Blouin, Ltd.*, 4 BTA 910, where about 2,400 copper tubes, each about two inches in diameter and four feet long, are part of a sugar evaporator in which cane juice is boiled in the sugar-making process. Generally the life of a tube is from two to four years. Some tubes are replaced every year, and in the one year under consideration all tubes were replaced. In the opinion the Board considered the question whether the replacement of all the tubes added materially to the value of the property. The Board allowed the expensing of the tubes in view of the fact that no value was added to the machine, except such value as was added by the fact that the machine was kept in an efficient condition.

In another case, *Hotel Sulgrave, Inc.*, 21 TC 619, New York City ordered the installation of a sprinkler system in a 60-year-old hotel building. The installation of the sprinkler system produced no additional income, added nothing

[*This paper, originally with extensive footnotes, appeared in the Tax Law Review for January, 1958. It is reprinted with permission. We bring you the text substantially unchanged, with the footnotes omitted.*]

to the rental desirability of the apartments, and did not reduce the cost of fire insurance. The taxpayer contended that the system was a repair which was made to keep the hotel properly in ordinarily efficient operating condition; it did not add to the value (and clearly did not prolong its estimated life to compute depreciation). The court found the sprinkler system to be an improvement or betterment having a life of more than one year. The court further commented that, while the system may not have increased the value of the hotel property, the property became more valuable in the taxpayer's business by reason of compliance with the City's order.

Likewise, if some entire structural unit is added as a replacement, generally there is added value through improvement. Furthermore, the capital character of an addition is not changed into an ordinary and necessary business expense because the related payments are made for a reason such as to compromise a law suit.

Thus necessary replacements or useful improvements which materially add to the value of the property in the hands of the taxpayer for use in his business must be capitalized even though the market value of the whole property shows no perceptible increase. But, on the other hand, if an item merely permits continued, ordinarily efficient operation of the property, it may be deducted as an expense, provided the added value arises solely from keeping the machine in efficient operating condition.

Repairs, reconditioning, improvement

It has been said that the distinction between the terms "repair" and "replacement" is one of degree and not of kind. Therefore, while certain repairs, standing alone, may properly be classified as periodic repairs, such items should be capitalized if they are part of the same general scheme of reconditioning and improving and altering property.

In *Joseph Merrick Jones,* 24 TC 563, *aff'd* 242 F.2d 616, taxpayer acquired a deteriorated building in the oldest and one of the most interesting parts of the French Quarter in New Orleans. Mr. Jones' architect recommended demolition of the building, but a New Orleans Commission having authority to preserve the architectural and historic value of such buildings would not approve demolition of the building. At the time of acquisition the building had no remaining useful life. Mr. Jones proceeded to recondition the building, claiming as a deduction such items as repainting exterior brick work, repairing cracks in masonry, repairing fire escape rail, replacing fallen plaster, repainting woodwork and replacing broken window panes. The Court sustained the disallowance of all the items as repairs in the nature of ordinary maintenance expenses. They were expenditures which were part of an over-all plan to restore the building to an operating condition. Since the expenditures materially added to the value of the building and gave the building a new useful life as a rental property, they cannot be separated from the general plan and purpose..

Although not always clearly distinguished in the cases, the capitalization of repairs which are part of a general plan of improvement should be distinguished from repairs where the deduction is denied because the repair items are not clearly segregated in the record from the cost of the improvements.

Repairs maintaining efficiency

Generally, repairs which do not materially extend lives or which do not substantially add to value are for the purpose of keeping property in good operating order. The continued operation of a packing plant in *Midland Empire,* 14 TC 635, was threatened by the seepage of oil into the basement rooms which had been satisfactorily used for twenty-five years for curing and storage of meat. The source of the oil seepage was a neighboring refinery which was constructed long after operations were begun in the meat packing plant. To remedy the situation, taxpayer lined the basement walls and floor with concrete which effectively sealed out the seepage. The expenditures did not allow the plant to be operated on a changed or larger scale and they did not make the plant suitable for new or additional uses. Since the repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it previously had been used, the Court allowed the deduction as an ordinary and necessary expense. It should be noted that taxpayer contended in the alternative that the expenditure to prevent oil seepage should be treated as the measure of the loss sustained during the taxable year which was not insured or otherwise compensated for. Here an emergency expenditure, caused by an unforeseeable external factor, involved the involuntary preservation of property. Similar borderline expenditures have been allowed as deductions where they are required to protect or restore the normal operating efficiency of property damaged or threatened by relatively sudden external factors having casualty aspects, such as storms, falling water level, and underground cave-ins.

In a case involving farmland terracing to prevent gullying of the land and loss of topsoil from the rapid run-off of water, the Commissioner disallowed the expenditures as a permanent capital improvement to land. The taxpayer successfully argued that the terracing was properly an ordinary and necessary expense, since the purpose served by the work was to maintain the farms in an ordinarily efficient condition for carrying on the kind of farming which had been followed before the terracing was done, as well as to preserve the normal productivity of the farmland.

Most repairs involve substitution of new parts or ingredients for old. But if a major unit or structural part is replaced, such as roof, wall, or floor, which results in extended life, the item clearly may not be deducted as a repair.

Replacement may be repair

However, even though an item might be an improvement under a technical definition, it may be so insignificant in relation to income that it would be absurd to require its capitalization. For example, one lessee might be justified in capitalizing an expenditure for a mattress or rug, while another operating on a larger scale and with substantially identical recurring expenditures might be justified in deducting the expenditure as an expense, if it consistently followed such accounting and tax reporting practice. Thus one court has said that the classification of an expenditure as capital or expense depends on the exercise of judgment in the light of circumstances and good accounting principles.

The practical effect of this flexible standard has been properly to develop the fairly widespread practice of consistently expensing capital items of, say,

up to a cost of $10 in the small professional office, while at the same time causing the consistent expensing of certain capital items running into hundreds of dollars in heavy industry such as steel. Such minimum capitalization policies may be sound only when consistently applied within the framework of that taxpayer's over-all capitalization policy. In any event, such policies should apply only to those frequent repair items of a capital character which are not of material size in view of the character of the related operations.

It is only practical that expenditures to replace small parts of a large machine may be deducted currently, since the replacement serves to repair the machine as a whole. On the other hand, when a building is erected the flooring, nails, and small supplies clearly enter into the capital cost of the building; but when a building is repaired, the cost of such items generally may be expensed. Furthermore, the character of a repair which is admittedly ordinary and necessary is not required to be capitalized merely because it was made soon after the acquisition of the asset.

It is interesting to note that replacements are not necessarily capital items even though they may have a life of more than one year. In order to overcome water pockets which developed in the subgrade of a railroad track, poles were driven into the ground at the ends of the ties. The fact that the beneficial effects of this work continued for approximately 15 years was not enough to overcome the repair character of the expenditure. After the poles were driven, the repaired parts of the railroad tracks were no more useful than the other parts which had not needed such work, and accordingly a deduction for repairs was allowed.

The question of classifying an item as capital is one of fact, which can best be determined by looking to the purpose and effect of the work. For example, if the erection of a temporary roof and the enclosing of finished sections of a new building with temporary partitions is for the purpose and has the effect of allowing the taxpayer to continue his operations pending completion of the new building, expenditures for such construction may be deductible. Also, a substantial and costly underground structure, created as a new part of taxpayer's plant and having a life of more than one year, may be expensed if the purpose and effect of the work is merely to enable continued operation of the plant on the same scale and at the same degree of efficiency at which it had operated before. On the other hand, the purpose and effect of expenditures for painting and repairing cracks in masonry indicate their capital character where the purpose and effect cannot be separated from an over-all plan for the general rehabilitation, restoration, and improvement of a deteriorated and fully-depreciated building.

The broad distinctions between expenditures which are capital and those chargeable against operating income have best been summarized by the following oft-quoted language from *Illinois Merchants Trust:*

"In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the *purpose* for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the *purpose* of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that *purpose* are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or adapt it to a different use."

Segregation of the facts of any repairs case into rigid artificial classifications, such as we have adopted to facilitate our analysis, is somewhat unsatisfactory, since the fact-picture must be reviewed as a whole before an intelligent decision as to the proper character of the item in question can be made. Reliance on just one or two of the broad aspects which we have considered could be fatal, since other unexplored circumstances might well result in a contrary conclusion.

As in most tax questions, the burden of proof rests with the taxpayer, who must establish that the item in question is not a capital expenditure. Accordingly, the taxpayer should be careful to make sure that all appropriate facts, evidencing purpose and effect, upon which the court must judge the case are in the record, or the issue obviously may be lost regardless of the merits.

Although the general principles in the repairs area have not changed substantially in many years, the Tax Court each year continues to decide additional cases in this area. Presumably, repairs cases will continue to arise, not only because large numbers of taxpayers employ physical property requiring repairs in their trade or business or as income producing property, but also because of the accelerating trend toward automation in many businesses. Indeed, since it is evident that the distinction between repairs and capital expenditures is one of fine degree, the judgment of parties with opposing tax interests, let alone the impartial judges themselves, cannot always be expected to agree where the line should be drawn. ☆

More executives would favor current dollar depreciation if allowed for taxes

MANY ACCOUNTANTS believe that corporate reports showing depreciation based on historical costs are so misleading to stockholders (and to others who rely on them—employees, their unions, regulatory agencies and the general public) that there would be less harm in adopting some less-than-perfect method of reporting depreciation in terms of current value dollars than in continuing the presently accepted method. While this is a question of financial reporting, all recognize that giving tax effect to such a change would be a powerful factor in obtaining widespread acceptance. Indeed, there is much concern over the fact that historical cost depreciation results in taxation as income of amounts which are really needed to replace worn-out equipment at higher dollar costs. The two problems are just different results of the same basic trouble.

A recent survey by the American Institute of Certified Public Accountants, designed to find out the attitude of corporate executives and of academic accountants, asked for opinions not only on the desirability of changes in financial reporting, but also whether their attitude toward a change would be different if any new method could also

be used for tax purposes. The result is not surprising. Whereas only 27% of the corporate executives would favor using current dollar depreciation for financial reports if it were not acceptable for taxes, 77% would favor it if acceptable for taxes.

Text of questionnaire

The Technical Services Department of the AICPA sent a questionnaire to 669 corporate executives and educators. It received replies from 331 in business and 75 in academic life. The full analysis of the replies, together with quotations from comments the Institute received, is published in the June issue of the Journal of Accountancy. We bring you here the text of questions 4 and 5, relating to the tax issue, and the tabulation of the replies received by the Institute.

In answer to question 4 "Would you favor reporting to stockholders a figure for net income which reflects charges for current cost depreciation, if current cost depreciation were accepted for income tax purposes?" replies, analyzed by industry groups, appear in column 1 below:

In answer to question 5 "Would you favor reporting to stockholders a figure for net income which reflects charges for current cost depreciation, even if current cost depreciation were not accepted for tax purposes?" replies were:

Answers to Question 4:

Group	Answers Yes	Answers No	Per Cent Yes	Per Cent No
Automobile, Aircraft and Related Industries	17	5	77%	23%
Building Materials	12	2	86	14
Machinery and Equipment	35	10	78	22
Chemicals, Paper, etc.	14	5	74	26
Railroad Equipment, Shipbuilding and Shipping	7	3	70	30
Steel	10	0	100	0
Mining and Metals	8	4	67	33
Petroleum	7	3	70	30
Food, Drugs, Beverages and Tobacco	19	7	73	27
Other Manufacturing	22	6	79	21
Retail and Services	8	6	57	43
Railroads and Public Utilities	9	7	56	44
Finance & Insurance	34	3	92	8
	202	61	77%	23%
Educators	48	17	74	26
Total	250	78	76%	24%

Answers to Question 5:

Group	Answers Yes	Answers No	Per Cent Yes	Per Cent No
Automobile, Aircraft and Related Industries	7	15	32%	68%
Building Materials	4	9	31	69
Machinery and Equipment	13	29	31	69
Chemicals, Paper, etc.	2	16	11	89
Railroad Equipment, Shipbuilding and Shipping	4	6	40	60
Steel	4	3	57	43
Mining and Metals	5	8	38	62
Petroleum	2	7	22	78
Food, Drugs, Beverages and Tobacco	1	25	4	96
Other Manufacturing	8	20	29	71
Retail and Services	2	11	15	85
Railroads and Public Utilities	3	13	19	81
Finance & Insurance	13	22	37	63
	68	184	27%	73%
Educators	44	19	70	30
Total	112	203	36%	64%

New accounting decisions this month

Gain on real estate subdivision sales is capital; agent handled it. The land in question was taxpayer's summer home. After she had sold some acreage, she was approached by a land development company which purchased the remaining land, subject to a purchase money mortgage. Before the development company had sold any of the land, it defaulted and taxpayer repossessed the land. She thereafter entered into an agreement for another company to develop the land for her. Taxpayer under this new arrangement bore all the costs of development and had a right to veto any sale. She, however, took no personal part in the development. On these facts the court of claims holds that taxpayer is not in the business of selling real estate, therefore the gains on the sales are capital gains. *Gordon,* Ct. Cl., 3/5/58.

Agreement is sublease, not assignment; gain not capital. Taxpayer as a lessee of premises for $1,600 a month entered into a three-way agreement (which they called a lease) with the lessor and telephone company, providing for the leasing of the premises to the telephone company at a rental of $1,900 a month to the lessor and a payment of $2,260 a month to taxpayer. The court is of the opinion that the transaction as consummated was a sublease, not an assignment of taxpayer's lease and holds the amounts received by taxpayer were rental income and not capital gain. *Voloudakis,* 29 TC No. 116.

"Rental" payments under lease-option capital. Payments received by taxpayer under a two-year lease-option contract on farm land are held to constitute payments on purchase price, not rental income. The court finds the lessee had originally negotiated to buy the property; the property had a value substantially in excess of the option prices, and the parties contemplated that the "rental" payments should constitute payments on purchase price. *Alexander,* TCM 1958-43.

Capital gain on sale of subdivided land. Taxpayers bought undeveloped land at a tax sale and transferred it to a corporation. The corporation subdivided the land and then liquidated. Over a seven-year period, taxpayers made 24 sales, representing 10% of the acreage. They engaged in no selling activity. The court holds they were not dealers in real estate and the gains are capital gains. *Goldstein,* DC Wash., 3/8/58.

Gain on sale of oil machinery by oil drilling company capital. Taxpayers were in the business of operating oil and gas wells. During 1951 and 1952 they sold some of the wells and some undeveloped property, as well as the equipment to go with it. They sold some new equipment that they no longer needed. The court holds that the gain on the sale is a capital gain, since the property was used in taxpayer's business. *Hart,* DC Tex., 2/27/58.

Advances to controlled corporation nonbusiness bad debt. Taxpayer advanced funds to a corporation of which he was president and controlling stockholder. The corporation being insolvent, he now seeks a business bad debt deduction for the advances. The court denies it because he failed to show that his activities of promoting, organizing, managing, financing or making loans to other businesses were of sufficient frequency and regularity to put him in the business of promoting corporations. To lend money to a business which you own does not

make the debt a business debt, since the business of the corporation is not the business of its officers and stockholders. *Wilbor, Jr.*, TCM 1958-45.

Gain on subdivided realty is capital. Taxpayer and his brother purchased unimproved real estate upon which the county installed roads, sewers, curbs and water lines. The brothers sold 102 lots to controlled corporations in two blocks, and 333⅓ lots to outsiders as one block. The sale of the 333⅓ lots was at a price far less than could have been obtained by selling off the lots individually. There was no listing, advertising or effort to sell. The court finds lots were not held primarily for sale, but for investment and thus the gain on the sale is capital. *Tibbals*, TCM 1958-44.

Needn't accrue interest from hopelessly insolvent debtor. Taxpayer, a railroad corporation, owned over 90% of the stock of a subsidiary. In 1929 it lent the subsidiary over $45,000,000 evidenced by interest bonds. Both corporations were on the accrual basis. For the period 1930 to 1935 taxpayer had accrued interest due from the subsidiary, but after 1935 it made no further accruals as the subsidiary was hopelessly insolvent. In 1942 and 1943, due to abnormal war earnings, the subsidiary paid taxpayer interest for the years through 1938. The Commissioner contended that, during 1942 and 1943, taxpayer should have accrued interest for those years due it from the subsidiary. The court disagrees, and holds the collections in 1942 and 1943 were properly applied to bond interest due up to 1938. Since there was no reasonable expectancy that taxpayer would be paid any of the interest due for 1942 and 1943 within a reasonable time thereafter (the subsidiary was not only insolvent then, but still owed taxpayer over $25,000,000 of past due interest), taxpayer was not required to accrue any of the current interest. *Chicago & North Western Ry. Co.*, 29 TC No. 104.

Capital gain on profit participation received for shares. After a number of disagreements with other stockholders, taxpayers, who was a minority stockholder and creditor, agreed to sell his stock to the corporation, a motion-picture company. For the stock he received a right to participate in profits from future pictures. The Tax Court held that these payments were not part of the purchase price for the stock. The participation in profits was compensation or other ordinary income, since it was not based on the liquidating value of the corporate assets. This court reverses. The bargaining position of the taxpayer was strong, and the corporation might well have been willing to pay more for his stock than its liquidating value. The case is remanded to the Tax Court. *Finney*, CA-9, 3/19/58.

Prior decision does not bar reconsideration of depreciation rate. In litigation over a prior year the Tax Court fixed depreciation based on production at 15¢ a barrel produced. The court now upholds the Commissioner in setting a new rate. The previous decision is no bar to a reconsideration of the unit rate where the estimates of useful life proved to be erroneous due to changed conditions and experience. Each tax year must be treated separately and, if changed conditions can be shown, then the doctrine of collateral estoppel is no bar. *Cumberland Portland Cement Co.*, 29 TC No. 126.

Gain on farm subdivision sale held capital. Taxpayers, farm owners, were approached by a developer who wanted to subdivide and sell the acreage for them. The promoter would carry out the entire operation in return for 15% of the selling price. All taxpayers did was sign the deeds. The court holds that the gain on the sale is capital. *Schuhmacher*, DC Tex., 3/18/58.

Corporation may deduct full loss on sale of unsuitable real estate. Taxpayer purchased real property for use in its business. The property was later, but before title was taken, found to be unsuitable for taxpayer's use and was sold at a loss. The IRS rules that, in determining whether the property was used in the business (loss would be ordinary under Section 1231, the old 117(j)) it is the original purpose for which the property was purchased that determines the character of the property. The loss here, it concludes, is an ordinary loss. *Rev. Rul.* 58-133.

Returnable containers depreciable; gain on unreturned is ordinary. Returnable containers which have a useful life of approximately 10 years, and for which a deposit is required, are considered property used in the trade or business, subject to the allowance for depreciation. However, when the time specified for the containers' return has expired, depreciation ceases and the containers then become property sold to customers during the regular course of business. Accordingly, gain or loss from unreturned containers, and from forfeiture of deposits, is to be treated as ordinary income or loss. *Rev. Rul.* 58-77.

Depreciable life of building determined by jury. Taxpayers claimed that the depreciable life of a building they owned was 25 years; the Commissioner claimed it was 30 years. The jury, after hearing expert testimony, determined the useful life to be 25 years. *Ash Corp.*, DC Va., 1/24/58.

Housing project can't depreciate cost of streets given to locality. Taxpayer owned a housing project. It used as its depreciation basis all the costs of the project except direct land cost. The Tax Court holds the costs of clearing, grading and landscaping are part of the land cost and non-depreciable. The costs of constructing sidewalks, curbs, paved streets, sewers and water mains, which were turned over to the local government for public use are also non-depreciable since the housing project retained no depreciable interest in the facilities. [The court does not discuss how taxpayer will recover this cost, though, since the decision is based on the analogy to special assessments for roads, etc. The implication is that they are a land cost recoverable on its sale.—*Ed.*] *Algernon Blair, Inc.*, 29 TC No. 128.

Salvage adjustment not required for emergency amortization. The Code permits amortization of emergency facilities to the full extent certified, even though they may have a remaining salvage value, but depreciation cannot be taken to reduce other assets' basis below salvage value. If depreciable assets are partially certified as an emergency facility, only the uncertified cost of the facility would be subject to the depreciation allowance. Accordingly, only the estimated salvage value on the uncertified portion is to be taken into account in computing depreciation. *Rev. Rul.* 58-131.

Deduction of demolition cost allowed on signing contract. Taxpayer, an accrual basis corporation, had in 1922 rented property in the harbor area from

the City of Los Angeles. The lease required the removal of all the structures from the property on termination of the lease in 1956. In 1950 taxpayer entered into an agreement with the Union Oil Co. whereby Union would remove the structures at the termination of the lease and taxpayer would pay the removal cost of $66,000 over the next six years to an escrow fund. The fund was to be paid to Union upon successful removal of the structures. No opinion is reported; the court states as a conclusion of law that taxpayer's accrual of the $66,000 in 1950 was proper. The transaction was not for tax avoidance and the expense was an absolute, present and fixed liability. *Uniharbor Corp.*, DC Calif., 2/25/58.

Accrued charitable contribution deduction denied; proper election not made. The Code allows the deduction by a corporation of a contribution unpaid at the year end provided it is paid within two and a half months, authorization in the minutes is made and a copy of the resolution is attached to the return. Taxpayer here made the payment within the limited time, but the court disallows the deduction because there was no resolution for the gift in the year claimed. The regulations specifically deny an accrual deduction under these circumstances. *Wood-Mosaic Co.*, DC Ky., 2/20/58.

Can't accrue interest expense while payment is only contingent. Taxpayer, a real estate corporation, borrowed from banks on the security of its land and also issued subordinate obligations to builders improving these lands. While these builders' notes provided for interest from the date of execution, no interest would be payable until the indebtedness to the bank was entirely paid. The case was submitted to the jury on the question of whether it was a reasonable certainty the notes with interest would be paid. Notwithstanding a jury verdict in favor of taxpayer, the district court held, and this court affirms, that while bank indebtedness is outstanding, there is no liability for interest on the builders' notes and none can be accrued. *Guardian Investment Corp.*, CA-5, 3/12/58.

Book and return treatment of research can vary. Research and experimental expenditures may be deducted for tax purposes in the year incurred as provided by Section 174(a) even though the expenditures are recorded on taxpayer's own financial statements as capital account charges or deferred expenses. *Rev. Rul.* 58-78 .

Settlement of claim is income on receipt; constitutes "abnormal income" for excess profits tax. An accrual basis taxpayer operating a suburban bus line had been receiving a ½-cent service fee from the City of New York to meet the cost of accounting for combination subway-bus riders. In 1948 it sought an increase in the allowance, but did not settle with the City until 1952, when it agreed to a one-cent service fee retroactive to 1949 and 1950. Since taxpayer had no legal right to the increased service charge prior to 1952, the court holds the settlement was accruable only in 1952. However, as the allowance of the additional ½-cent was intended to compensate for services performed in 1949 and 1950, it constituted "abnormal income" to taxpayer in 1952 within the meaning of 1939 Code Section 456, and as such was exempt from excess profits tax that year. *Triboro Coach Corp.*, 29 TC No. 133.

Bonus paid before March 1951 deductible in 1950. The Code disallows the deduction of certain accrued expenses due related cash-basis taxpayers unless the liability is paid within two and a half months of the close of the year in which accrued. The jury here finds that a bonus payment was made prior to March 15, 1951, although the books of the corporation give its date as March 19, 1951. Thus taxpayer, an accrual basis corporation, could deduct the bonus from its 1950 income. *Hightower Box and Tank Co.*, DC Ala., 3/14/58.

DEDUCTIBILITY

Transferee can't deduct interest for period prior to its liability. Taxpayer bought the stock of a corporation for a price determined as a fixed amount plus the excess of current assets over current liabilities at a date. Shortly thereafter the taxpayer liquidated its newly acquired subsidiary. It was subsequently determined that the income tax liability of the purchased company was higher than the amount estimated at the time of sale, and the seller of the stock met the obligation. Pointing out that the formula for determining the price had no relation to the question of whether the interest on the taxes was a liability of the purchaser, the court concludes that taxpayer as successor and transferee was liable for the interest—it was its valid indebtedness and deductible. However, the interest for the period prior to liquidation may not be deducted. For this purpose interest must be regarded as accruing ratably over the period for which the funds were available, not under the rule which determines that interest on taxes accrues for deductibility on settlement of the controversy and determination of the amount. *Central Electric & Gas Co.*, Ct. Cls., 3/5/58.

Can't deduct penalty for late filing of local tax. Taxpayer paid a penalty for late payment of a local mercantile license tax and sought to deduct the penalty as interest. The court denies the deduction, holding that the statute intended the penalty to be something other than interest, namely a punishment for non-payment of taxes when due. Taxpayer also argued in the alternative that it should be allowed to deduct the penalty as a business expense since it resulted from an innocent violation of the law, but the court notes that the tax ordinance did not distinguish between innocent and willful violations, and to allow the deduction would frustrate state policy by mitigating the prescribed punishment. *Keystone Metal Co.*, 29 TC No. 131.

Corporation can deduct commissions to related partnership. Payments by a selling corporation to a partnership acting as its sales agent are held to be an ordinary and necessary business expense. The fact that the partners were also officers and stockholders of the corporation was deemed not material since the amounts paid were for actual services performed, were reasonable, and were not in proportion to the partners' stockholdings. *Royal Cotton Mill Co.*, 29 TC No. 84.

Loss on sale, part of larger transaction, not proved. Taxpayer claimed a loss on the sale of its tangible property in two producing oil wells. The properties had a basis of some $330,000 and they were sold for $250,000. However, the court finds that the sale was only part of an integrated transaction in which the oil leases themselves were transferred with the tangible property and, in addition to the $250,000, taxpayer retained an oil production payment of $3,600,000

out of 85% of the production. Taxpayer did not show, the court holds, that the consideration for the tangible assets was only the cash received, therefore it did not prove a loss. *Kline*, 29 TC No. 117.

Lump-sum payment held rent, not lease acquisition bonus. Taxpayer leased a hotel. In compromise of a lawsuit by the landlord claiming additional rent under a differing interpretation of the lease, taxpayer paid the landlord a lump sum and signed a new lease without the ambiguities of the old. The Commissioner asserted the payment was a bonus on signing the new lease and must be amortized over its life. The court holds that the payment was rent. The idea of a bonus to the landlord is not reasonable in view of the fact that the new lease was on the whole less favorable to the taxpayer tenant than the old lease. Consequently the payment is deductible when made. *Pritzker Foundation*, DC Ohio, 3/7/58.

Overceiling wage payments disallowed. A partnership engaged in the painting and decorating business paid overceiling wages to workmen in violation of the Defense Production Act. The Tax Court held the excess amounts were properly disallowed as a deduction from partnership income. Taxpayer argued that the wages constituted a part of its "capital cost" and that under the Sixteenth Amendment a tax can be laid only on income arising after all investment is recouped. While seeing considerable merit in this argument, "upon the principle of stare decisis, if upon no other," this court stands by its position in *Weather-Seat* (16 TC 1312, *aff'd*, CA-6, 199 F.2d 376). There it held that the price control laws in effect provided that overceiling wages are not reasonable compensation. *Solon Decorating Co.*, CA-6, 3/13/58.

Bad debt deduction denied for advances to deceased farm manager. Taxpayer as owner of farm properties entered into an agreement with one Davis whereby taxpayer would furnish Davis with lands and fertilizer and Davis would furnish everything else to operate a farm. The crops produced were to be shared on a 50-50 basis. Because Davis had no funds, taxpayer made substantial advances to him to enable him to carry on the farming operations. Davis was later killed, and taxpayer was named administrator of his estate. Taxpayer claimed a business bad debt deduction for the unpaid balance. The court denies the deduction. Taxpayer did not show the existence of a net indebtedness due him. Taxpayer's books and records were concededly haphazard. An action pending against taxpayer, as administrator, by Davis's heirs for misappropriation and waste raised the possibility that a proper balancing of debits and credits would show a substantial balance in the estate's favor. *Barbour*, 29 TC No. 108.

Bank can't deduct reimbursement to stockholder-president for bonding loss. The president of taxpayer bank entered into an agreement bonding trustees of an estate which was a substantial customer of the bank. When the president subsequently had to make good on the bond, taxpayer bank reimbursed him. The bank received none of the bonding fees and was not legally liable on the bond. The court holds that paying the bond was not an ordinary and necessary expense of the bank. While there was a verbal agreement among the stockholders that the bank would repay any losses that the president sustained on the bond, this was not binding on the bank and the payment of the expense of another is not deductible. *Okemah National Bank*, CA-10, 3/10/58.

Expenses of illegal business allowed. Expenses paid by a gambler for the printing and production of lottery tickets and losses incurred by him in the operation of a bar which was conducted without a liquor license are allowed as business deductions in the light of the Supreme Court's decision in the *Sullivan* case, allowing the expenses of an illegal business. *Cohen*, TCM 1958-55.

Mortgage interest paid prior to assumption of liability not deductible. Taxpayer lived in his new home for several months while the purchase agreement was being completed. At the time of final settlement taxpayer paid the "interest" on the mortgage for the time he occupied the house. The IRS rules that taxpayer-purchaser may not deduct the payment since he had no debt obligation on the mortgage. *Rev. Rul.* 58-129.

Health insurance premiums for employees are deductible. Health insurance premiums which are paid by a corporate employer on individual policies for the sole benefit of key employees who are not stockholders are deductible as ordinary and necessary business expenses. However, the same insurance premium if paid by a sole proprietor on insurance in behalf of himself would be a non-deductible personal expense. *Rev. Rul.* 58-90.

Over-ceiling cash payments for merchandise includible in cost of goods sold. Taxpayers, dress jobbers, had included in their cost of goods sold cash disbursements which they alleged had been made to various suppliers in violation of OPA price ceilings in order to obtain scarce merchandise. Conceding that these payments would be deductible if proved, the Commissioner disallowed the sums for lack of substantiation. On the facts, the court finds the payments were actually disbursed as alleged and holds they are an allowable part of the cost of goods sold. *Five Star Dresses, Inc.*, TCM 1958-40.

No deduction because AP lost monopolistic value. The N. Y. Sun is not permitted to deduct the cost of its AP membership. That membership lost all its value when the Supreme Court invalidated AP's monopolistic practice of limited membership, and when the AP voluntarily changed its bylaws. The Tax Court held there was no justification for the deduction in the absence of a sale or other disposition of the membership which taxpayer still owned and used in its newspaper business. This court affirms. *N. Y. Sun*, CA-2, 3/19/58.

Worthless loans deductible as non-business bad debt. Loss on loans made by taxpayer to an unrelated partnership are held to be non-business rather than business bad debts. Taxpayer did not show he was in the business of promoting organizations. *Starr*, TCM 1958-50.

Loss is denied for a worthless claim assigned in cancellation of debt. A construction company performed some work for a school. In cancellation of the school's indebtedness to it, the company took an assignment of the school's claim pending before the Veterans Tuition Appeals Board. The assignment of the claim was effected by a partner of the school who was also a member of the construction company. The court finds the claim was worthless on the date of the assignment and could not be taken as a loss deduction by the company at a later date. Nor could the can-

cellation of the indebtedness on the assignment effect a deduction since the debt from the school was not proved worthless when canceled. *Fink,* 29 TC No. 118.

Loan to potential customer not a business debt. Taxpayer was a member of a partnership engaged in the manufacture of dies and metal stampings. He advanced funds to a newly organized corporation in which he held a 25% stock interest. The corporation was in the separate business of painting and decorating metal and ceramic items. When the corporation was unable to pay back the loans, taxpayer claimed a business bad debt deduction on the ground that his advances were made to bolster the corporation with the expectation that it would provide a market for the output of the partnership. The evidence showed that, although the loans were made in 1949, the books of the partnership reflected no sales to the corporation in the succeeding years. The court concludes the loans bore no proximate relationship to the business of the partnership or that of taxpayer as a partner, and were, therefore, deductible only as a non-business bad debt. *Nichols,* 29 TC No. 121.

WHAT IS INCOME

Valueless co-operative certificates not income [*Acquiescence*]. Taxpayer received revolving fund certificates from a co-operative of which he was a member. These certificates represented undistributed and exempt earnings of the co-operative used for capital expansion. The certificates bore no interest, had no retirement date, were non-transferable without the consent of the co-operative, and were junior to all debts of the co-operative. The Tax Court holds that, since the certificates had no fair market value, their receipt is not income to taxpayer. That the income is tax exempt in the hands of the co-operative is no reason for charging another entity with income that he did not receive. *Carpenter,* 20 TC No. 603, *acq.* IRB 1958-11.

Goodwill payments upon lease of going service station not advanced rent. Taxpayer corporation had a number of retail gasoline stations and leased several of them at an agreed rental plus a fixed payment for goodwill, which was equal to the price the taxpayer had paid for the station's goodwill. The court finds that it is customary, in acquiring service stations, either by purchase or lease, to pay "goodwill money" and holds the payments received by the corporation were not advance rentals as contended by the Commissioner, but amounts actually realized from the sale of goodwill. Since the goodwill was sold at its cost, taxpayer realized no income. *Chatsworth Stations, Inc.,* 29 TC No. 120.

Life insurance agent taxable on commissions for own policies. Taxpayer, an agent for a life insurance company, took out policies on his own life and also on the lives of various associates. He received the regular commissions on these policies, which he contended were a reduction of the premium, rather than income. The court upholds the long-standing ruling that the commissions are taxable, noting that it would be unlawful for the company to sell taxpayer insurance at a reduced rate. *Ostheimer,* DC Penna., 3/4/58.

Receipts were salary, not loan repayment. Taxpayer was a majority stockholder and an officer of a corporation and its subsidiary, both of which encountered financial difficulties. Taxpayer advanced funds to both. The subsidiary deposited funds in taxpayer's personal bank account which taxpayer claimed were repayment of loans. The court finds that the deposits preceded the loans and were salary income which taxpayer then lent to one or both of the corporations. *Creswell,* TCM 1958-54.

Bargain purchase taxable as compensation for services rendered. Taxpayer was a stockholder-officer of the corporation which owned the land leased to Yonkers Raceway. He arranged for the sale of some of its stocks and bonds by other stockholders to two friends of his. The form of the transaction was a sale to taxpayer, who retained some stock and bonds and sold the rest to the friends. The securities retained had a value some $45,000 in excess of their cost to taxpayer. This the court finds was compensation. Despite the form of the transaction, taxpayer was not a mere purchaser; the bargain purchase was in reality compensation for arranging the deal. *Lynch,* 29 TC No. 124.

No income on cancellation of installment note. Taxpayer sold real estate to his son, taking back installment notes for most of the purchase price. He reported the gain on the installment basis. In a later year he canceled the notes, intending a gift to his son. Under the regulations, gain is realized on a "distribution, transmission or disposition" of an installment obligation, measured by fair market value, but in the case of a "satisfaction" or a sale or exchange, gain is measured by the amount realized. The court concludes the gratuitous cancellation of the notes is a satisfaction, and since nothing was realized, there is no taxable gain. *Miller,* DC La., 3/8/58.

Union "lockout" benefits taxable to recipients. Lockout benefits, cash or goods, paid to both members and non-members of a union are includible in income even though distributed on the basis of need. *Rev. Rul.* 58-139.

Security risk suspension payment is income. Reimbursement for wages lost when an individual who was later cleared was suspended as a security risk constitutes taxable income since the settlement is essentially a substitute for wages earned. *Rev. Rul.* 58-140.

OTHER DECISIONS

Automobile corporation president sold auto insurance as individual. Taxpayer was a corporation in the business of selling cars and trucks. Its president personally sold insurance policies on cars sold only by the corporation, although in prior years he had written insurance on cars sold by other dealers. Insurance commission checks paid direct to the president of the corporation by the insurance company are not income of taxpayer corporation. The sale of insurance was not an integral part of taxpayer's sale of the cars; taxpayer was not licensed to sell insurance; the records and the accounting kept the two activities wholly separate. *Moke Epstein, Inc.,* 29 TC No. 105.

Pre-death depreciation reduces survivor's basis for joint property. The IRS expands *Rev. Rul.* 56-519 to show how depreciation prior to the death of one spouse affects the surviving spouse's basis for property held by them as tenants by the entirety. The particular situation ruled on was that of a surviving wife whose interest in the property was of three kinds: (1) she had paid part of the original cost (less than half) out of her

own earnings; (2) the difference between her investment and a one-half interest in the property was acquired upon the purchase of the property jointly; (3) she received the remaining half upon the death of her husband. For the first portion, her basis is her cost less depreciation allowed or allowable to her prior to the death of her husband. For the second portion, depreciation allowed or allowable to her must also be deducted. No depreciation adjustment is required for the third. *Rev. Rul.* 58-130.

Jury finds no constructive receipt in agreement postponing payment. In 1948 taxpayer delivered wheat to a grain elevator with the specific agreement that payment would not be made until January 1949. Upon instructions of the judge explaining the constructive receipt doctrine, the jury finds the payment did not constitute income until 1949. *McIntyre,* DC N. Dak., 2/13/58.

Pre-1913 depreciation does not reduce cost for retirement accounting. Taxpayer railroad retired in 1940-1943 certain equipment acquired prior to 1913. The parties stipulated that the cost should be accepted as being the same as a 1917 reproduction cost determined by the ICC. However, the Commissioner insisted that this cost must be reduced by pre-1913 depreciation. The court disagrees—it would be inconsistent with the theory of retirement accounting to recognize any reduction of basis until retirement. This is the position the Tax Court has taken in many similar cases, approved by appeals courts. *Chicago & North Western Ry. Co.,* 29 TC No. 104.

Property was acquired by purchase; basis is cost not predecessor's basis [*Certiorari denied*]. Taxpayer contended that it should be allowed as invested capital the basis of the assets in the hands of the predecessor owner, a receiver in bankruptcy to a court order for sale. The district court found that the transfer was a sale, not a tax-free reorganization. This court affirms. *Select Theatres Corp., cert. den.* 3/31/58.

Bank discontinued record storage in basement after flood; no deduction for loss of building. The bank claimed $76,000 casualty loss which the Commissioner disallowed because only negligible physical damage had been actually done to the bank building, though the bank no longer used its basement for storage of its records after a serious flood had inundated the basement, destroying all its records. The claimed deduction was computed as the difference between the fair market value before and after the flood. The Fourth Circuit affirms the Tax Court's denial of the deduction. While a casualty loss may arise not only from physical destruction but also from abandonment because of the casualty, the bank here failed to show permanent abandonment of even the basement. The loss will be recognized only on sale of the building or a showing of complete abandonment. This claim is based essentially on a fluctuation in value. *Citizens Bank of Weston,* CA-4, 2/14/58.

Abandonment loss allowed though line was not removed. Taxpayer had constructed a gas-gathering pipeline at a cost of some $40,000. In 1952 it plugged the well from which the line ran and has not used either since. Geological reports indicated that the well and pipeline would never be worth operating and the line was worth less as salvage than the cost of removal. The court allows an abandonment loss in 1952; physical destruction of equipment is not a prerequisite to an abandonment loss. *Mississippi River Fuel Corp.,* DC Mo., 2/5/58.

Losses on motion pictures denied. In 1943, taxpayer purchased a film about the Nazis for commercial exhibition. He persisted in attempts to market the film, which he finally sold in 1951. The Tax Court denied a deduction for worthlessness in 1945, as taxpayer did not consider the picture worthless upon the fall of Nazi Germany and did not establish that it became worthless at any other time during the year. A deduction in 1945 for the loss of another film was also denied because taxpayer made no effort to obtain recoupment of the price from the unauthorized seller who was not shown to have been insolvent. This court affirms since the Tax Court's holding is not clearly erroneous. *Finney,* CA-9, 3/19/58.

Income tax, reduced by uncontested adjustments, deductible for operating loss when incurred. The court previously determined that taxpayer is permitted to deduct its 1944 excess profits tax in determining the amount of a loss carryover. In subsequent negotiation to determine the exact amount of the recovery, taxpayer and the Government were unable to agree on the proper amount, the question at issue being whether the 1944 tax should be reduced for certain accruals claimed by the taxpayer on its 1944 return. The Commissioner on examination of the return had reduced the amounts deductible and taxpayer had acquiesced. The Court holds that the rule as to contested items is inapplicable because there was no contest. The 1944 excess profits tax to be used is that as determined by the Commissioner and accepted by the taxpayer. *National Forge & Ordnance Co.,* Ct. Cls., 3/5/58.

For operating loss, can deduct EPT first accrued despite later renegotiation. The Supreme Court held in *Lewyt* (349 U.S. 237) that the phrase "paid or accrued" must be given the same meaning in the computation of net loss carryovers as it has in other parts of the Code. Here taxpayer is permitted to include in his computation of 1946 operating loss carried back to 1944 the 1944 excess profits tax paid or accrued in 1944. The court holds this means the 1944 excess profits tax computed under the usual rules for accrual. In this particular case it is the tax computed on 1944 income without regard to the fact that renegotiation of 1944 business was made in later years and 1944 income reduced. In that renegotiation 1944 excess profits tax was recomputed under special statutory provisions which do not, the court holds, affect the operating loss computation. For that purpose only occurrence in 1944 may be considered. Consequently the 1946 carryback is to be computed as absorbed by 1944 income (reduced by renegotiation) less original 1944 tax. [The court merely remarks in a footnote that the parties stipulated in *Lewyt* that income was reduced by the renegotiation refund.—*Ed.*] *Continental Foundry & Machine Co.,* Ct. Cls., 3/5/58.

For operating loss, cash basis taxpayer deducts EPT when paid. In computing an operating loss carryover, a taxpayer is permitted to deduct excess profits tax "paid or accrued." There was much litigation over whether this phrase was to be interpreted as meaning in accord with taxpayer's accounting system, or whether it meant the tax applicable for the year of the loss. The Supreme Court held in *Olympic Radio and Television* (349 U.S. 232) that the phrase must be interpreted as meaning in accord with taxpayer's system. That case involved an accrual basis taxpayer. The taxpayer

here is on the cash basis, but the same rationale applies, and it deducts the tax paid, regardless of the fact that in a later year, upon renegotiation, its income was reduced and it obtained a reduction of tax. *Stratford Engineering Corp.*, Ct. Cls., 3/5/58.

Income taxes not operating-loss expense. An individual may not treat state income taxes, interest on state and Federal income taxes and litigation expenses in connection therewith (even though related to income derived from a trade or business) as "business" expenses. They are not deductible in arriving at adjusted gross income, nor are they includible in computing an operating loss. In the operating-loss computation, they reduce his non-business income which, if a net income, reduces the operating loss. *Rev. Rul.* 58-142.

Loss on sale of farm equipment net operating loss (Old Law) [*Acquiescence*]. Taxpayer, a farmer-rancher, acquired a herd of breeding cattle as a separate business. In 1952 he decided to discontinue the breeding operation, to fatten the breeding cattle, and to sell them for beef as soon as possible. The court holds the loss on sale of the breeding cattle was not a net operating loss resulting from the "operation of a business" as required by the 1939 Code but rather resulted from a "termination" of a business. However, the court does allow the loss on sale of a combine as an operating loss because that loss was purely incidental to the farming business and did not result in any diminution of that business. [Under the 1954 Code losses from the disposition of property used as a business are operating losses. *Ed.*] *Cluck*, 29 TC 7, *acq.*, IRB 1958-13.

Charity returned gift; not income but tax saving must be repaid. In 1944 taxpayer had created a trust to which he gave land and securities to be used to construct a public library in his town. In 1953 the town decided not to build the library and the trust corpus was returned to taxpayer. The court concedes that this transaction does not come under the statutory tax benefit rule which applies to recoveries of taxes and interest only. However, it holds that the statute left untouched and still valid the case law on tax benefit, which indicates (and the Regulations so provide) that the principle is applicable to all recoveries of payments which resulted in a tax benefit. However, in trying to reach an equitable solution the court does not require the taxpayer to include the recovery in income; it holds that he must add to his 1953 tax otherwise computed the tax reduction effected in 1944 by the shift. Two judges dissent; this kind of meticulous computation was not required by the case law nor was it adopted by Congress when it codified part of the tax benefit rule. They think the court should follow the simpler rule requiring the inclusion in income of the recovery, the related deduction for which resulted in a tax benefit. *Perry*, Ct. Cls., 4/2/58.

Can deduct privilege taxes consistently claimed for base year. Taxpayer, a public utility, had consistently accrued deductions in each month of 1952 and 1953 for the New Jersey Gross Receipts and Franchise taxes, which it paid in 1953 and 1954. The taxes, although based upon sales for 1952 and 1953, were actually imposed for the "privilege year" in which the payments were due. The court holds that, since taxpayer had consistently accrued and deducted recurring taxes in the base period year, for many years with the Commissioner's acquiescence, the Commissioner could not change that procedure to require that the deductions be taken in the succeeding year of payment (the "privilege year"). *Atlantic City Electric Co.*, TCM 1958-25.

Initial contributions to community TV antenna system are income, not a gift or capital contribution. Taxpayer constructed and operated a community antenna television system. Only those persons who made contributions to taxpayer's system were eligible to use it upon further payment of monthly charges. A contributor could not transfer his eligibility, but he remained eligible even though he moved to a different section of the area. The Tax Court held the "contributions" were not gifts or contributions to capital; they were part of the payment for services rendered or to be rendered and were therefore includible in taxpayer's gross income. This court affirms. The doctrine of *Cuba Railroads* (268 U. S. 628), in which subsidies by the Cuban government were held not income, is yielding to a gradual but persistent broadening of the concept of income, as exemplified by *Glenshaw Glass* (348 U. S. 426), holding that triple damages are income. *Teleservice Co. of Wyoming Valley*, CA-3, 3/24/58.

Embezzlement loss deductible when discovered. Taxpayers' manager embezzled $600,000 from 1949 to 1952 and voluntarily confessed in 1952. Upon learning of the loss, taxpayer filed refund claims for the open years, allocating the loss over the four-year period. This was the method then required by IRS rulings, but when subsequently the Supreme Court's decision in *Alison* (344 U.S. 167) indicated the deduction might be taken in the year the loss was discovered, taxpayer amended its return so as to take the whole deduction in 1952. The court holds for taxpayer; the entire loss is deductible in 1952. It had not elected to follow a contrary method since it had no choice prior to *Alison* but to follow the IRS rulings. [1954 Code Section 165(e) specifically requires a theft loss to be deducted in the year of discovery.—*Ed.*] *Interstate Financial Corp.*, DC N. Y., 2/24/58.

Interest payable out of profits accrues when profits are earned. When taxpayer's preferred stock was sold to investors in 1925, the holders of the common stock, two German corporations, to make the issue more attractive, guaranteed that the preferred would receive dividends for four years. The German corporations actually paid about $800,000 to preferred stockholders under this agreement. Taxpayer agreed to pay the parent corporations out of profits the sums advanced, plus interest. In 1940, the taxpayer accrued the full amount of interest, about $450,000, on the ground that not till then did it have profit out of which to pay the interest. The court finds the interest accrued in 1939. The agreement provided that reimbursement should not be made "except out of profits" of taxpayer. Taxpayer argued that this meant profits after deduction of the preferred dividends, and since dividends in arrears were paid in 1939, there was nothing left to meet the liability for the 1925-29 debt and interest. Only when 1940 earnings came in was taxpayer required to make payment and only then did interest accrue. However, the district court held that the word "profits" in the agreement had its usual meaning, i.e., without deduction of dividends. The liability to repay arose in 1939 and interest accrued then. This court affirms. *American Bemberg*, CA-3, 3/14/58.

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY RICHARD L. GREENE, LL.B.

Does the "two-shot" corporation escape collapsible treatment under Section 341?

by J. BRUCE DONALDSON

Section 341 does not adequately restrict the collapsible corporation of the "two-shot" type because it was designed and drafted with the classic collapsible prototype in mind. Like a gill net, it is well woven to catch the fish for which it was originally cast, but it is not at all adequate to cope with the eels that can go slipping through. Mr. Donaldson examines the provisions of Section 341 and its application to several typical "two-shot" construction ventures.

COLLAPSIBLE CORPORATIONS have had a dynamic evolution. Spurred by sharply advantageous tax results and given breadth by diverse facets of application, this type of corporation quickly gained wide and polished usage. Almost without transitional pause, preventive legislation followed.

Section 341 of the 1954 Code is the present statutory vehicle for meeting the collapsible corporation problem. The section is neither simple nor clear. To many, the difficulties created in determining the areas of encompassment have proved vexatious and the statute represents an obstacle; to others, the existence of a specific provision, regardless of how technical, invites ingenuity and the statute represents an opportunity for circumvention. Somewhere between these approaches lies the course of wisdom.

It is the purpose of this article to examine the status under Section 341 of the so-called "two-shot" corporation. Such a corporation is one which constructs two separate projects, disposes of one and is then collapsed. This type of corporation is susceptible of use in many industries, e.g. oil, motion picture and construction. However, here all examples will be drawn from, and focus will center on, the residential construction field.

Section 341 provides the definition of a collapsible corporation and prescribes that shareholders, upon collapse through sale, liquidation or otherwise of a collapsible corporation, shall realize ordinary gain unless certain specific limitations operate. A presumption relating to the section's applicability is also included.

The section operates as an integrated statutory whole. However, all parts of the provisions are not of equal importance to the type of corporation under consideration; only the parts of the section and certain construction difficulties which arise under these parts are discussed.

Definition and substantial realization

Section 341 defines a collapsible corporation as one "formed or availed of principally for the manufacture, construction, or production of property," or for the purchase of Section 341 assets, with a view to realization by its shareholders of the gain attributable to the property through liquidation, sale of stock, or distribution, before realization by the corporation of a substantial part of the income to be derived from the property.[1] The definition is deceptively clear; underneath this surface clarity lie difficult technical and semantic problems. One of the problems is that of measuring and determining what constitutes substantial realization.

The collapsible corporation definition requires that collapse take place before corporate realization of a substantial part of the income to be derived from the *property* manufactured, constructed, produced or purchased. As a preliminary to the application of the substantial realization test, it is necessary to determine what constitutes the relevant property to which the test is to be applied. The Regulations provide that reference should be made to each separate property constructed, manufactured, produced or purchased as to which the subjective view to collapse existed. This separate property approach is modified where an integrated project is involved. "Where . . . such property is a unit of an integrated project involving several properties similar in kind . . . the determination must be made by reference to the aggregate of the properties constituting the single project." Reg. 1.341-2 (a)(4).

Under the Regulations, therefore, each separate property or integrated project is tested separately to determine whether substantial realization as to that property has occurred. In effect, it is the position of the Regulations that, so long as one separate asset does not meet the substantial realization test, the corporation remains within the collapsible corporation definition.

After focusing on the appropriate property, the next step is to compute the total income to be derived from the property. A comparison is then made of the realization at the corporate level to determine if it is substantial in reference to the total income to be derived from the property. The method of computation urged by most commentators and apparently accepted informally by the Internal Revenue Service, is to add together (1) the income which has occurred from the property in the corporation, and (2) the amount of gain which would be realized upon a sale of the property at the date of collapse. Recently, this approach received judicial approval and application. *A. E. Levenson et al.*, (DC Ala., 12/11/57). No contrary authority exists.

[1] Also included are corporations "formed or availed of" for the holding of stock in a "collapsible corporation." Section 341(b)(1).
[2] Section 312(b) relates to corporate distributions in kind of inventory or unrealized receivables; Section 312(j) deals with treatment accorded distributions having a source in federally insured financing.
[3] Although it is not altogether clear, it seems to be the approach dictated after careful analysis is made of Reg. 1.341-4(c)(4).

What percentage of realization at the corporate level constitutes substantial within the intendment of the section is not presently clear. Thus far, the IRS has no promulgated position. The *Levenson* case holds that corporate realization of more than 50% is clearly substantial. Most writers also take this position. For convenience in discussion it will be assumed that 50% constitutes substantial realization.

Operation of the section

Section 341(a) carries the taxing impact of Section 341. Assuming a corporation comes within the orbit of definition of a collapsible corporation, Section 341(a) provides that the gain from:

1. sale or exchange of stock, or

2. distribution in partial or complete liquidation which is treated as a sale or exchange, or

3. a distribution which is treated, to the extent it exceeds the basis of stock, in the same manner as a gain from the sale or exchange of property, shall be treated as gain from the sale or exchange of non-capital assets.

Section 341 operates only where, but for its provisions, the gain realized on collapse would be considered long-term capital gain. Thus, the section does not apply where the gain is non-recognized or short-term, nor does it apply where, by virtue of Sections 312(b) or 312(j)[2] a distribution is treated as a dividend.

Section 341 appears to cover all possible methods of collapsing a corporation, i.e. sale or exchange of stock, corporation liquidation and distributions before realization of corporate earnings and profits, except one, redemption under Section 302. This apparently was a result of an oversight in drafting the section. Section 341(a) refers to distributions in complete or partial liquidation, which are "treated under this part," as an exchange for stock. "This part" obviously refers to Part II, Corporate Liquidation; since redemptions under Section 302 are covered in Part I, Distributions by Corporations, Section 341 does not technically reach such distributions.

Limitations on the operation of Section 341 are contained in subsection (d). There are three such limitations each of which functions independently of the others.

The first limitation, contained in subsection (d)(1), exempts from the operation of Section 341 stockholders owning, directly or indirectly, less than 5% of the stock of the corporation. This limitation virtually eliminates widely held corporations from the orbit of the collapsible provisions.

Subsection (d)(2) provides that Section 341 does not apply to gain recognized on collapse of a corporation, unless more than 70% of such gain is attributable to the property so manufactured, constructed, produced or purchased. This is the so-called "70-30" rule.

Serious classification problems arise in applying this limitation; determination must be made of the relevant unit of property and consideration must be given the effect of corporate realization as to a specific property. The Regulations provide that, in applying the limitation, reference must be made to each separate property or integrated project which has been manufactured, constructed, produced or purchased. Unless substantial realization has taken place as to each such property, the gain attributable to that property is classified on the 70 side of the "70-30" rule. Surplus attributable to income derived from those properties which remain collapsible is also placed on the 70 side. All other property falls to the other side.

After completion of the classification process, computation is made as follows:[3]

1. Determine the fair market value of the shareholder's pro rata share of the corporation's net assets as of the collapse date and subtract the shareholder's basis for the shares.

2. Ascertain the shareholder's pro rata share of the appreciation over adjusted basis of the collapsible assets and his pro rata share of surplus attributable to collapsible assets.

3. Compare the result of the second computation to determine whether it represents more than 70% of the first.

Where the limitation applies, the entire gain enjoys the benefit of capital gain treatment; where it does not, the entire gain is treated as ordinary.

Subsection 341(d)(3) provides a three-year rule which frees property held for more than three years after completion of manufacture, construction, production or purchase, from the operation of Section 341. The problem of what constitutes the relevant unit of property is also present as a preliminary to the application of this limitation. The importance of this question arises out of the necessity for fixing the date of completion. The last act upon a particular unit in an integrated whole may have occurred more than three years prior to collapse, while work on the project as a whole continued until much later; depending upon what constitutes the relevant unit of property, subsection (d)(3) may or may not apply. It is probably safe to assume that a separate property or integrated project approach constitutes the position of the IRS in this area. Application of subsection (d)(3) results in immunization of the gain realized on the specific property from the operation of Section 341.

A corporation is not disqualified from the definition of collapsible corporation by virtue of application of one of the (d) limitations; subsection (d) acts on and limits only the operative taxing provision of Section 341, namely, subsection (a).

The "two-shot" corporation

As the collapsible corporation originally evolved, the corporate lifespan covered a single economic transaction. The central core of the original collapsible idea included three mechanical steps: formation of a corporation, production of property in the corporation and realization of the profit attributable to the property through sale of the stock or corporate liquidation.

Section 341 was enacted to deal with the collapsible corporation in its classic prototype. The structure of the section and the statutory technique employed are designed to deter an avoidance device with specific mechanics.

The "two-shot" corporation is an offshoot of the collapsible idea. Such a corporation is one which is characterized by production of two separate properties, realization of the gain attributable to one, followed by collapse. A key difference between the one- and two-transaction corporation is the incident of realization of income at the corporate level. Underlying the "two-shot" corporation is the tax stratagem of allowing some income at the corporate level, with the expectation, through the circumvention of Section 341, of achieving a single capital gain as to the balance of the

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profit. Should the stratagem fail, double tax as to a portion of the profit penalizes the attempt. Should the plan succeed, at least to enterprisors subject to high surtax, an attractive tax result is achieved.

How it works

The following are four illustrations of "two-shot" corporation use. Each example differs as to mechanics and as to the structural weak point in Section 341 at which it is aimed.

1. *Simple "two-shot" corporation.* Quality Builders, Inc. is incorporated by A and B; each transfers $1,000 to the corporation in exchange for one-half of the common stock. The corporation purchases two separate tracts of land each containing 25 residential building sites. Quality Builders constructs 25 residential units on each tract and, after completion, sells all the houses in one tract. Upon these sales a unit profit $1,000 is realized, or a total net profit of $25,000. Federal income tax on the net profit is $7,500 and $17,500 is left to surplus. The residences on the second tract have a fair market value of $25,000 above cost.

Quality Builders, Inc. liquidates. Gain on liquidation to A and B consists of their pro rata share of corporate surplus of $17,500 in cash, and 25 homes which have a fair market value of $25,000 in excess of existing financing obligations which are a lien thereon.

Section 341, technically, does not reach the gain upon liquidation. Subsection (d)(2), the so-called "70-30" rule, operates to prevent application of Section 341 as follows: upon liquidation, under the integrated project rule of the Regulations, reference is made to each separate tract project. As to one project substantial realization has occurred and consequently the surplus, in the form of cash, generated out of this project is not collapsible property. Inasmuch as such surplus amounts to 41.1% of the gain upon liquidation (17,500 ÷ 42,500), the limitation of subsection (d)(2) applies. The entire gain on liquidation qualifies as capital gain.

The effective tax rate imposed on the profit from the fifty homes is 36.25%, 30% corporate tax on the income realized at the corporate level plus a maximum 25% upon the gain on liquidation.

2. *"Two-shot" corporation with redemption out.* Assume the same facts as in the Quality Builders, Inc. example except as follows:

A enjoys high bracket income, B's income is moderate. After completion of residential units on each of the two tracts, sale is made of all the houses in one tract. Quality Builders, at that point, redeems all of the stock of A. A redemption distribution is made in the amount of $18,500 which represents the capital investment of $1,000 and the $17,500 after tax profit on the residential units sold.

Quality Builders, Inc. continues normal operations until the homes located on the second tract are substantially disposed of and then liquidates.

As to A, section 341 does not, under a strict interpretation of its wording, operate. As pointed out above, Section 341(a)(1) does not cover distributions under Part I, Distributions by Corporations. Under Section 302, a distribution which is complete redemption of the entire stock interest of one stockholder is treated as an exchange and qualifies as a capital gain. Of course, B has not benefited from a tax aspect. However, many factors, such as A's superior real estate development background or financing sources might influence his participation.[4]

3. *Shopping center development.* Suburban Development, Inc. is incorporated, A and B each transferring $10,000 to the corporation in exchange for one-half of its common stock. The corporation purchases a large tract of suburban land one corner of which is suitable for development of a shopping center.

Say one hundred residential houses are constructed and sold. A shopping center, financed by the profit from the residential unit sales, is constructed and the commercial space is leased to various national merchandising concerns.

Suburban Development, Inc., after the lapse of three years from construction, liquidates. After liquidation A and B immediately sell the shopping center.

Section 341 does not apply to the gain realized upon liquidation. Subsection (d)(3) frees the gain from the application of the section since the property distributed in liquidation was held more than three years after completion of construction.

4. *Parent-subsidiary "two-shot" combination.* Residential Homes, Inc. is incorporated by A with initial capital of $87,500. The corporation purchases a tract of land for $50,000 containing 50 subdivided lots.

Residential Homes, Inc. and B, a general realtor, cause incorporation of Style-Wise Homes Co. Original capital, $50,000, is provided and stock issued as follows: Residential Homes, Inc. provides $37,500 in exchange for 75% of the stock and B contributes $12,500 for 25%. Style-Wise acquires 50 building sites at $1,000 each, constructs homes thereon and disposes of 30 of these homes over a two-year period at a profit of $30,000. From this profit, Style-Wise declares a dividend of $21,000 and satisfies corporate tax of $9,000.

Residential Homes, Inc. builds 50 houses; each unit has a value of $1,000 in excess of cost. At that point, Style-Wise Homes is liquidated and distributes in liquidation 20 homes which have a value of $20,000 in excess of construction mortgage indebtedness and land cost. Residential Homes, Inc. realizes a gain on liquidation of $15,000 which is subject to tax at a rate of 25%, or $3,750.

Thereafter, Residential Homes, Inc. liquidates and distributes in liquidation $11,291 in cash and 65 homes which have a value of $65,000 in excess of construction mortgage indebtedness and land cost.[5] The gain on liquidation to A is $76,291, which bears tax at a rate of 25%, or $19,072.75.

Style-Wise Homes does not come within the definition of a collapsible corporation since, as to the 50 homes constructed, substantial realization preceded liquidation. Residential Homes, Inc. avoids the operation of Section 341 by virtue of the application of Subsection (d)(2), the "70-30" rule. Upon liquidation, $50,000 of the total gain of $76,291 is attributable to collapsible property, and since this amount is less than 70% of the gain, the limitation applies. The effective rate of tax upon A's part of the profit from the transaction, $87,500, is 34.7%.

It is not suggested that all, or any, of the transactions set out can confidently be expected to produce the tax results indicated. Obviously, substantial jeopardy is involved in most. This risk must, in the final analysis, be measured against the benefit which will flow from

[4] A more advantageous result to B might be achieved by the following modifications. After completion of the houses, 13 units are sold in one tract and 12 from the other. At that point A's stock is redeemed. Following this the thirteenth unit in the second project is sold and Quality Builders, Inc. is liquidated. Section 341 might not apply to the gain on liquidation since substantial realization as to each project has occurred.

[5] The cash represents the dividend from Style-Wise, $15,750, less corporate tax, $709, after giving effect to the dividends-received credit, less tax incurred on liquidation of Style-Wise; 15 homes received from Style-Wise Homes on liquidation and the 50 homes constructed by Residential Homes, Inc. make up the 65 homes.

success and the penalty which will follow from failure.

Section 341 was designed to cope with the collapsible corporation device. In an attempt to be specific the statute is complex. Moreover, the effort, through precise definition and mechanical limitation, to define the section's exact areas of encompassment also results in outlining its outer boundaries. The "two-shot" corporation aims at skirting Section 341 while achieving the desired avoidance result. It is concluded that Section 341 is not, from a technical or structural standpoint adequate to circumscribe the "two-shot" corporation. ☆

How to plan a safely thin corporation in the face of today's obstacles

by ***GERALD J. KAHN***

This is a practical guide for the tax man advising on the formation of a new corporation. Mr. Kahn sets out the type of note, corporate minutes and records which, in the light of current cases, will be most likely to achieve successful thinness. As an aid to long-range planning, he discusses briefly proposals to insert a definite standard in the Code itself.

THE THIN CORPORATION has probably received more extensive treatment in the tax literature than any other single subject. The justification for such concentration lies in (1) the considerable tax advantages to be reaped from a successful thin corporation and (2) the fact that the only practicable means by which many a closely held corporation may secure adequate financing is through the creation of a thin corporation.

Thin capitalization

The thin corporation, that is, one having a disproportionate ratio of debt to equity, is financed partially by shareholders' loans and partially by capital investments. With respect to the capital furnished by loans, the principal tax benefits incidental thereto are: (1) the periodic payments to the lenders are deductible by the corporation as interest; (2) the repayment of the advances is tax free and (3) the loss sustained, if the corporation fails, is deductible as an ordinary loss in the case of a business bad debt, and as a short-term capital loss in the case of a nonbusiness bad debt. While it is true that the capitalization of many corporations takes the form of loans rather than stock in order to secure the foregoing favorable tax consequences, it is also true that closely held corporations are frequently limited in their sources of financing and may have to rely on shareholders' loans as a last resort where the shareholders are unwilling to place any more capital at risk.

There is such an abundance of literature on the subject and so many court decisions have been handed down since the Supreme Court first indicated in 1946[1] that thin capitalization is a factor to be considered in determining whether an instrument represents the interest of a creditor or that of a shareholder that it would seem that, by now, some pattern would have emerged to serve as a guide in the creation of a bona-fide debtor-creditor relationship. But the continuing litigation in this area indicates either the lack of reliable guideposts or the existence of a large group of unwary taxpayers. Perhaps it may also suggest that there is a substantial group of taxpayers who are taking risks without intelligently measuring the consequences.

That the ratio of debt to equity is but one element to be taken into account in determining the character of an instrument needs to be repeated. Thin capitalization by itself has never been the sole criterion for a finding by a court of debt or equity; at least, no court has so indicated. The courts have considered such other factors as the relationship of amounts loaned to stock interests, treatment on corporate records, fixed maturity date, duration of loan, interest payments, voting rights, subordination and the character of the use by the corporation of the advanced funds. While it is difficult to surmise how much weight will be given to capital thinness in any single case, it would be safe to conclude that a grossly excessive amount of alleged loans would influence a court to deny them that status. The Tax Court and the Internal Revenue Service have indicated that a debt-to-equity ratio of 3½ to 1 is not unreasonable,[2] but this is far from being conclusive. Just as there have been cases in which an instrument has been adjudged a security despite the existence of a ratio less than 3½ to 1, there have been cases where a ratio greater than the aforementioned has not prevented the finding of debt.[3]

As previously noted, planning the financing of a close corporation from a tax standpoint, whether at its formation or at some time thereafter, must give weight to many factors besides the quantum relationship of debt and equity. The extremely narrow approach taken by the Tax Court recently in construing transactions between shareholders and their corporations is admonition enough that utmost caution must be observed in creating a dual creditor-shareholder position.[4]

To enhance the chances that shareholders' advances to their corporation will be recognized as debt rather than equity, the following steps should be taken:

1. Loans by shareholders should not be in proportion to stock interests.[5] For example, where there are three equal shareholders, instead of having the shareholders each advance one-third of the debt funds, it is far better if one shareholder lends, say, 75% of the total, another 25%, and the third nothing.

2. The transaction should be handled as a loan by the shareholders and should so be designated on the corporate books and records.[6]

3. The advances should be reflected by notes conventional on their face and conforming to all the concepts of debt, that is, having a fixed maturity date for the principal sum which is reasonable in time,[7] calling for fixed annual payments

[1] *John Kelley Co. v. Commissioner*, 326 U.S. 521, (1946).
[2] *Ruspyn Corporation*, 18 TC 769, (1952), (acq., 1952-2, Cum. Bull. 3).
[3] Compare *Gooding Amusement Co., Inc. v. Commissioner*, 236 F.2d 159, (6th Cir. 1956-, *cert. den.* 352 U.S. 1031, (1957), and *Rowan v. United States*, 219 F.2d 51, (5th Cir., 1955).
[4] See *Gooding Amusement Co., Inc.*, 23 TC 408, (1954), *aff'd* 236 F.2d 159, (6th Cir., 1956), *cert. den.* 352 U.S. 1031, (1957); *Oreste Casale*, 26 TC 1020, (1956), *rev'd* 247 F.2d 440, (2nd Cir., (1957); *Pelton Steel Casting Co.*, 28 TC 153 (1957) *affd.* Jan. 7, 1958 (7th Cir.).
[5] *B. M. C. Manufacturing Corp.*, 11 TCM 376, (1952); *New England Lime Co.*, 13 TC 799, (1949).
[6] *Crown Iron Works Co. v. Commissioner*, 245 F.2d 357, (8th Cir. 1957), *aff'g* 15 TCM 1046, (1956).
[7] *U. S. v. South Georgia Ry. Co.*, 107 F.2d 3, (5th Cir., 1939); *Ticker Publishing Co.*, 46 BTA 399.

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in the form of interest[8] and possessing no voting rights.[9]

4. The shareholders' loans should not be subordinated to the claims of other creditors and should, if possible, be secured.[10]

5. A record should be made on the corporate minutes that the shareholders are unwilling to place any more capital at the risk of the business, that funds are not available through the ordinary sources of credit, and that the only way to obtain the additional required funds is by way of loans from shareholders.[11]

6. Adequate investment capital should be provided and the debt-to-capital ratio should probably not exceed 2 to 1. A record should be made of any good-will or going-concern value and of the market value of the corporate assets, if in excess of book value, at the time of the loans, because the foregoing enter into the computation of the debt-to-capital ratio.[12]

7. The funds advanced should be used for operating capital in the business, and not for the acquisition of fixed assets.[13]

8. Upon maturity of the notes, they should be paid. If the corporation still has need for the repaid sums, an entirely new loan should be made with new notes exchanged for the sums advanced.[14]

It is true that the courts in different cases have place varying shades of importance on the aforementioned factors. Nevertheless, the more favorable tax privileges accorded to debt justify a strict observance of the guideposts established by the courts. Shareholders who believe they are committing funds as loans, but are not careful, may find eventually that interest deductions will be disallowed the corporation, purported loan repayments taxed to them as dividends and, if the corporation becomes financially distressed, losses of the advanced funds treated as long-term capital losses.

In an effort to introduce objective tests to be followed in determining the tax status of shareholders' advances, the Advisory Group on Subchapter C of the Code recommended on December 24, 1957, to the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means that Section 317 be amended to include a definition of corporate indebtedness. The proposed definition is as follows:

(c) *Indebtedness.*—For purposes of this subtitle, indebtedness of a corporation shall include in all events (but shall not be limited to) any unconditional obligation of a corporation to pay on demand or on or before a specified and not unreasonably distant date a sum certain in money incurred upon a distribution to shareholders or for an adequate consideration in money or money's worth and under circumstances which do not negative any reasonable expectation of payment, if —

1. the obligation is not by its terms subordinated to the claims of trade creditors generally, and

2. by the terms of the obligation, payment, if any, for use of the principal amount is not excessive, is not dependent upon the earnings of the corporation, and is unconditionally due not later than the maturity date of the principal amount, and

3. the obligation does not by its terms entitle the obligee to vote upon the election of directors of the corporation, and

4. in case the obligation is initially held or guaranteed by a shareholder of the corporation, immediately after the obligation is created the principal amount of all obligations of the corporation held or guaranteed by its shareholders does not exceed by more than five-to-one the fair value of the outstanding stock of the corporation or the total of the capital and surplus paid-in with respect thereto, whichever is greater.

As is evident, the proposed statutory definition would not be limited to advances by shareholders, but would apply to all purported corporate debt. The proposed statute has specific reference to shareholders' loans only insofar as it provides that the ratio of shareholders' loans and corporate obligations guaranteed by shareholders to corporate equity shall not exceed five-to-one. (Of particular note, as will be seen hereinafter, is the commingling of guaranteed obligations with direct loans in the computation of the ratio.) However, as the report accompanying the proposed amendments indicates, the provision would serve its greatest purpose in the area of loans by stockholders to small closely held corporations.

Certainly, the desirability of a greater measure of certainty in this important area cannot be gainsaid. It would permit shareholders to make loans up to the 5-to-1 ratio with certainty of the tax treatment if all the other requirements are met. Taxpayers, however, might encounter difficulties in meeting the proposed requirements. There might be disagreement between taxpayers and the government as to what constitutes an unreasonably distant date, or an excessive rate of interest, or a fair value of the outstanding stock. However, it is to be hoped that, if such a provision is enacted, the IRS and the courts will not interpret it to require all corporate loans to meet its standard in order to qualify as debt. The Advisory Group left little doubt that this was not its intention by stating in its report that the proposed amendment is "to be without prejudice to the determination of the status of other alleged obligations not coming within its strict requirements."

Guaranteed loans

Tax advantages substantially similar to those attained through shareholders' loans may be available through other forms of transactions without incurring the same risks. One such transaction is the guaranteed loan, in which the corporation borrows funds from a third party, such as a bank, and the shareholders guarantee the loan. If the transaction is legitimate, the interest payments will be deductible by the corporation and the capital of the shareholders will not be tied up. Although the insertion of a third party between the shareholders and the corporation may make it more difficult for the IRS to challenge the validity of the transaction, nevertheless it is safe to predict that these transactions will not be immune to construction as capital contributions by the shareholders with funds borrowed by them from the third party. Surely the success of the government, in *Putnam*,[15] in having a guaranteed loan treated the same as a direct shareholder loan, in respect to the kind of loss sustained by the shareholders

[8] *Commissioner v. H. P. Hood & Sons*, 141 F.2d 467, (1st Cir., 1944); *Commissioner v. O. P. P. Holding Corp.*, 76 F.2d 11, (2nd Cir., 1935).
[9] *Crown Iron Works Co. v. Commissioner*, *supra*, Note 6.
[10] *Commissioner v. Meridian & 13th R. Co.*, 132 F.2d 182, (7th Cir., 1942); *Wetterau Grocer Co. v. Commissioner*, 179 F.2d 158, (8th Cir., 1950).
[11] See *Miller Estate v. Commissioner*, 239 F.2d 729, (9th Cir. 1956), *rev'g* 24 TC 923, (1955).
[12] *B. M. C. Manufacturing Corp.*, *supra*, Note 5; *Bakhaus and Burke, Inc.*, 14 TCM 919, (1955); *Auslie Perrault*, 25 TC 439, *aff'd* 244 F.2d 408, (10th Cir., 1957); *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, (2nd Cir., 1956), *rev'g* 21 TC 513, (1954); *Miller Estate*, *supra*, Note 11.
[13] *Rowan v. United States*, *supra*, Note 3.
[14] *Gooding Amusement Co., Inc.*, *supra*, Note 4.
[15] 352 U.S. 82, (1956).

upon the corporation's becoming defunct, portends little good for unwary taxpayers. But, notwithstanding the potential difficulties, this technique may be exceedingly useful to taxpayers in appropriate circumstances.

Leasing property to corporation

Another possible solution to the shareholder loan problem is that of having the shareholders lease property to the corporation, instead of attempting to create a creditor relationship with the corporation. The shareholders will first purchase in their own names certain property, such as a building, needed by the corporation and then lease it to the corporation. The rental payments will ordinarily be deductible by the corporation. To minimize the investment of their capital in the property for a long period, the shareholders can arrange to borrow the bulk of the purchase price. There are pitfalls in this kind of transaction, too. The rental to the corporation must be reasonable. In fact, the lease arrangement must be at arm's length in all respects as it will no doubt be subject to close scrutiny.

Whichever technique is used, be it shareholders' loan or another, the taxpayer should be advised of the risks involved. But in the final analysis, the stouthearted taxpayer can reap impressive tax advantages in this area by taking intelligent risks. ☆

New corporate decisions this month

Stock and loan in one package; can't deduct interest to stockholders. In order to finance the acquisition of a building by a new corporation, its two stockholders advanced it $10,000 for capital stock, $59,600 on notes, and negotiated a bank loan for $180,000. Although the notes issued satisfied the formal requirements for a corporate indebtedness, they could not be called unless the stock held by the parties was offered for sale at the same time. The court finds the stockholders in effect placed the notes and stock of the corporation in one package and finds the $59,600 represented capital contributions, rather than a bona fide indebtedness. An interest deduction for the stockholders' loan is denied. *Lockwood Realty Corp.*, TCM 1958-49.

Purchase by related corporation not essentially equivalent to dividend. Taxpayer controlled two corporations, one of which leased property to the other. Pursuant to a plan whereby the lessee would acquire control of the lessor corporation, taxpayer in 1952 sold about 20% of the lessor's stock to the lessee at his cost. However, he never transferred the remaining shares because he was warned of the possible adverse tax consequences. The court finds a business purpose in the lessee's acquiring control of the lessor in that continuity of the lease is assured. Although taxpayer was also found to be motivated by a need for ready cash, the sale is held not essentially equivalent to a dividend. [1954 Code Section 304 specifically governs purchases by a related corporation, subjecting them to possible treatment as stock redemptions equivalent to a dividend.—*Ed.*] *Busch*, DC Calif., 3/14/58.

Advances held capital contributions, not loans; ratio of debt to capital, 50 to one. Taxpayer was a majority stockholder of a corporation organized in 1946 with a beginning capital of $25,000 to manufacture toys. During the period from 1946 through 1949 he made substantial advances to the corporation on demand notes which he deducted in 1950 and 1952 as worthless business bad debts. The court notes that the ratio of indebtedness to authorized capital was more than 50 to one at the end of 1947 and holds the advances were capital contributions and not loans, so that there could have been no valid deduction for worthless debts. *Douglas*, TCM 1958-35.

Thin corporation loses interest deduction. An individual proprietor in the business of distributing oil well supplies and equipment transferred the assets and business to a new corporation in return for all the stock plus $100,000 par value of unsecured 20-year 5% debentures. The proprietorship had a book value of less than $12,000. The bonds were represented by a $100,000 addition to goodwill. Interest on some of the bonds was not paid. The court finds there was no justification for the small initial capitalization and that no corporate indebtedness existed with respect to the debentures. The corporation is denied a deduction of accrued interest on the bonds. *Texoma Supply Co.*, TCM 1958-36.

Guarantor who financed family corporation denied a business bad debt. Since 1883 taxpayer had been interested in many enterprises in a variety of businesses and frequently promoted and financed corporations. However, Tax Court held that he failed to prove that for the taxable year in question, 1951, and the immediate preceding years, his activities were so extensive as to amount to the conduct of a business of promoting, organizing, managing, financing and making loans to businesses. Accordingly his payment of $100,000 to a bank as guarantor of a note of an insolvent family corporation, and $18,000 which he had advanced to the corporation were allowed only as nonbusiness debts (short-term capital losses). The Tax Court also pointed out that in the light of the Supreme Court's *Putnam* decision, the guaranty loss had to be treated as a loss from a bad debt, not a loss from a transaction entered into for profit. This court affirms. *Ferguson*, CA-4, 3/6/58.

"Pension" to widow to discourage stock sale is a dividend. A stockholders' agreement among family members provided that, if any of them died, the remaining stockholders would cause the corporation to pay the surviving widow a pension, but only as long as she held the stock. The court finds the amounts paid under the agreement represent a corporate distribution of profit, and as such are taxable to the widow and are not deductible by the corporation. The fact that the corporation was not a party to the agreement and that the carrying out of its provisions was procured by the stockholders who wanted the stock to remain in the family was considered by the court as negativing any intention to make a gift or pay a pension. *Standard Asbestos Mfg. & Insulating Co.*, TCM 1958-42.

Stepped-up basis on liquidation though purchase was "brother-sister" under attribution. Taxpayer here bought all of the stock of a corporation and then liquidated it; the basis of the assets in the hands of the purchased company was less than the purchase price of the stock and taxpayer, as the new owner, would be permitted to use as basis its cost for the stock under the 1954 codification of the *Kimball-Diamond* rule unless it was forbidden because the basis

for the stock of the liquidated company depended on the basis to the seller of the stock. The IRS rules that taxpayer's basis for the stock did not depend on the seller's basis and, therefore, it has a stepped-up basis for the assets received on liquidation. The question arose because the buyer and the seller of the stock were related and that relation, magnified under the attribution rules, made them in effect brother and sister and subject to the rule covering sales of stock between them. Taxpayer, buyer of the stock, was 100% owned by one corporation which also owned 10% of the seller (the other 90% being held by unrelated persons). However, under the attribution rules the buyer as parent, because it owned even 1 share of the seller, is considered to own all the shares and thus is treated as owning all the stock of both buyer and seller. Then the transaction must be regarded as a brother-sister sale and is treated by the seller as a redemption and is a capital gain to it. The IRS says that similar treatment should be given the buyer and its basis for the stock bought should be cost. It follows that the basis for the assets received on liquidation is the basis for the stock. *Rev. Rul.* 58-79.

Stock was sold for cash plus preferred; not a reorganization [*Non-acquiescence*]. Taxpayer and the other owners of the common stock of Jack & Heintz engaged in a series of transactions whereby they transferred all their stock to Precision Products Corp., a corporation newly formed by outsiders to buy out taxpayer and other owners, for $5 million, plus 60,000 shares of preferred stock which they planned to dispose of quickly. Precision, a day later, merged Jack & Heintz into itself. The Commissioner contended the transactions were a reorganization and that the boot of $5 million received by taxpayer was ordinary income, being in effect a taxable dividend. The Tax Court disagreed. Since the transactions did not contemplate the taxpayers' maintenance of a proprietary interest in the continuing corporation, there was no reorganization. The exchange for cash plus preferred stock constituted a sale taxable at capital-gains rates. *Heintz*, 25 TC 132, *non-acq.*, IRB 1958-11.

No loss on redeeming bonds issued for assets with low tax basis. Taxpayer had issued some $10 million of its bonds in 1936 for assets which it took over (the transaction was part of a tax-free reorganization) with a basis of only some $7 million. It litigated and lost on the argument that the $3 million was in effect discount it could amortize. Now it asks for a $3 million deduction in 1945, the year it redeemed the bonds at par. This the court denies. It analogizes the transaction to a purchase for more than the true value of the assets and points out that a loss is allowable only when the assets are sold. The time of the payment, whether at purchase or upon maturity of the obligations issued, is not the time for allowance of loss. The court notes the contrary position taken in *American Smelting and Refining*, 130 F2d 883, (C-3, 1942), but refuses to follow it. *Montana Power Co.*, Ct. Cls., 3/5/58.

Exchange tax-free though first step was transfer to new subsidiary. Section 368(a)(2)(C) adds a new provision to the Code permitting a reorganization to be tax free although the acquiring corporation puts some or all of the assets acquired into a subsidiary. The IRS here rules on the effect of having the transfer to a subsidiary precede the acquisition rather than follow it. Here a loan company was owned 79% by one corporation and 21% by various others. It was desirable for business reasons to eliminate the minority, but direct merger into the parent was not practical because the parent was not qualified to carry on the loans business in the particular state. So the loan company transferred all its assets to a new subsidiary and then merged with its 79% parent. The IRS rules that, while the language of the Code seems to contemplate a transfer to a subsidiary after the acquisition of assets, there is no good reason why a transfer before should have a different tax effect. It rules that this transaction is non-taxable. *Rev. Rul.* 58-93.

Can't base loss on inter-subsidiary note in existence upon acquisition of group. Taxpayer had in 1930 acquired the business of Central Alloys. At that time Central had two subsidiaries, one of which owed the other $1,250,000. The form of the acquisition was that taxpayer issued its stock for the assets of the parent (including the stock of the debtor on the note) and for the assets of the creditor. Thus Republic held the note payable by its wholly-owned subsidiary. Upon liquidation of the subsidiary in 1937, Republic computed its loss by including the note in the indebtedness due from the subsidiary, which was in excess of the assets received. The court denies the loss because of the circumstances under which the note was issued. The debtor had created and transferred the note payable to its wholly owned subsidiary, together with all its manufacturing assets, in return for the subsidiary's stock and its assumption of liabilities. The debtor transferred the subsidiary's stock to Central Alloy, its parent, making Central the direct parent of both, as it was when Republic entered the picture. The debt had no real purpose other than to improve the balance sheet of the newly created subsidiary. Not being valid on inception, no loss can be based on it. Furthermore the note had no real cost to Republic. It acquired all three companies at once and the amount of offsetting inter-company debts was of no significance to it. *Republic Steel Corporation*, Ct. Cls., 3/5/58.

Subsidiary can deduct interest and service charges paid to parent [*Acquiescence*]. Taxpayer here had paid interest and service charges to its parent corporation in years it filed separate returns. The deduction was disallowed by the Commissioner under the authority of 1939 Code Section 45, relating to allocation of income and deductions among related taxpayers. The court overrules the Commissioner, holding that the charges were those which would have been made between unrelated enterprises dealing at arm's length and as such the amounts were reasonable and the purpose justified. *Seaboard Commercial Corp.*, 28 TC 1034, *acq.* IRB 1958-13.

Accumulated earnings unchanged by creating subsidiary to hold some assets. In 1951 taxpayer liquidated his wholly-owned corporation under Sec. 112(b)(7), under which he is not taxed on the unrealized appreciation of the corporate assets, but is required to treat as a dividend the accumulated surplus of the corporation. The question before the court is whether the corporation's earnings in 1948 should be treated as still being its accumulated earnings or whether some or all of them must be regarded as transferred in 1949 when the corporation created a wholly-owned subsidiary and transferred some of its assets to it. The court holds that the

accumulated earnings of the corporation were unaffected by creating the subsidiary. The court analyses at some length the cases (particularly *Sansome*, 60 F.2d 931, *cert. den.* 287 U.S. 667) on the treatment of accumulated earnings and deficits through tax-free reorganizations and finds its holding here is sustained by the two theories that run through the cases—earnings are considered transferred if necessary to prevent avoidance of their taxation and they are considered transferred to preserve continuity with the real interests. *Mansfield*, Ct. Cls., 3/5/50.

Withdrawals from corporation taxed as dividends. Taxpayer withdrew money from a corporation which she controlled as administratrix and sole heir of her father. The money was entered on the books as open account loans and was in excess of the earnings and profits of the corporation. The court holds the withdrawals were not loans, but were dividends to the extent of earnings and profits. The court finds that the stockholder had no intention of repaying the withdrawals. That the withdrawals were disproportionate to her personal interest in the corporation is unimportant since she controlled the corporation. Nor does the fact that the sum of the withdrawals exceeded the earnings and profits preclude treatment of the payments as dividends to the extent of earnings. *Roschuni*, 29 TC No. 127.

Automobile agency did not improperly accumulate surplus [*Acquiescence*]. A Pontiac automobile sales agency, whose stock was held by one individual, accumulated a surplus of almost $500,000, over half of which was invested in marketable securities. Though no taxable dividend had ever been declared by the corporation, the court nevertheless finds the corporation was not liable for the surtax on improper accumulations of surplus. The working capital needed to fulfill the agency's agreement with General Motors, coupled with the expenses of physical expansion, and the continuing possibility that it might be required to finance a new dealership in adjoining territory were considered sufficient to account for the surplus accumulation. *Breitfeller Sales, Inc.*, 28 TC 1164, *acq.*, IRB 1958-13.

Election for "one-month" liquidation not revocable. Under the elective provisions of the "one-month" liquidation rule (section 333 of the 1954 Code.) property of the corporation received in liquidation is taxed as a dividend to the extent of the corporation's earnings and profits. The balance of the liquidation gain is, under certain conditions, deferred. Taxpayer elected to proceed under this section in liquidating his wholly-owned corporation and later discovered that the surplus shown on the books was less than the earnings and profits for tax purposes because the accountant had written off $50,000 goodwill. As a result, the amount taxed as an ordinary dividend was $50,000 more than taxpayer had expected. The court refuses to permit him to revoke his election. His mistake as to the amount of earnings and profits, which induced the election, was one of law for which no relief can be granted. *Raymond*, DC Mich., 3/5/58.

Local law ignored in determining gain on sale of assets of dissolved corporation [*Certiorari denied*]. Taxpayer, a trustee of a dissolved Hawaiian corporation, had, after the certificate of dissolution was issued, sold assets of the corporation at a gain, and argued that under Hawaiian law there was no longer any corporation and therefore he sold the property on behalf of the stockholders individually. The Ninth Circuit, however, upholds the Treasury Regulation that sales of property by trustees in liquidation are to be treated as if made by the corporation for the purpose of ascertaining gain or loss. Irrespective of local law, this regulation continues the life of a corporation for tax purposes. *Loo, cert. den.*, 4/7/58.

Holding period for liquidation recognition and for capital gains different. The 1954 Code (like the 1939) contains a provision permitting liquidation of a corporation within one month and taxation of the gain to the shareholders as a dividend to the extent of each one's share of accumulated earnings and as a capital gain to the extent of the receipt of cash and securities acquired after a cut-off date, now 12/31/53. The purpose of this cut-off date is to prevent avoiding the gains tax by investing cash in securities after the passage of the law. The question here is whether this cut-off is applicable to securities received for stock after the date from its sole stockholder. The IRS holds it is; it distinguishes previous rulings in which other acquisitions in non-taxable exchanges were held to date back to the receipt of the stock given up on the ground that those reorganizations were mere changes in form of stock previously acquired. The transaction here, however, was the same as a contribution of cash for stock by the stockholder and the purchase of the securities with the cash. *Rev. Rul.* 58-92.

Loans to shareholders evidence of unreasonable surplus accumulation. The Tax Court upheld the Section 102 [Section 531 of the 1954 Code.—*Ed.*] penalty against taxpayer. Evidence before the Tax Court showed taxpayer's shareholders had taken only nominal salaries but had withdrawn substantial sums as loans. The working capital of taxpayer was adequate for its potential volume of business. This evidence supported the Tax Court's finding of unreasonable accumulation of surplus to avoid the surtax on its shareholders. This court affirms. *Kerr-Cochran, Inc.*, CA-8, 3/11/58.

$80,000 a year reasonable salary for part-time president. Taxpayer fertilizer corporation paid its president $100,000 a year and its vice-president $90,000 a year. The Commissioner allowed as a deduction $41,000 and $31,000 respectively. The testimony disclosed that, despite a shrinking industry, taxpayer's firm had been expanding and had become established as a leader in the industry. Taxpayer offered no testimony on comparable salaries, claiming that there was no comparable firm. Commissioner poined out that taxpayer's president was absent for four months every year and that the president and vice-president were the sole stockholders of taxpayer corporation. However, the court noted that the Commissioner's evidence of salaries paid by other firms did not show that the other firms were comparable. The court holds that a reasonable salary for each of the officers is $80,000. *Bluegrass Plant Foods, Inc.*, TCM 1958-53.

Officers' salaries unreasonable. Salaries paid by taxpayer corporation to each of three officer-stockholders during the years 1949, 1950 and 1951 in the amounts of $52,200, $65,200 and $65,200 respectively, are held to be unreasonable in the light of the services rendered. The court finds the evidence negatived taxpayer's argument that part of the compensation received in each of the years was in-

tended as reimbursement for services performed in prior years. On the basis of all the evidence submitted, it concludes that compensation of $42,500 is properly allowable to each officer for 1949, and $47,500 to each for 1950 and 1951. *Standard Asbestos Mfg. & Insulating Co.*, TCM 1958-42.

Cannot deduct additional compensation to corporate officers. Salaries paid to the officers of taxpayer, a real estate corporation, in the amount of $3,000 and fees paid its directors in the amount of $1,200 are held to be reasonable compensation for services rendered. An additional $1,500 paid to the vice-president for supervising the properties is disallowed for failure of proof of the supervisory services. *Northline Realty Corp.*, TCM 1958-21.

Reasonable compensation for officers' services determined. $6,000 paid as management fees to two officer-stockholders of a real estate corporation (approximately 11% of gross rentals) is held to be unreasonable compensation. The court allows $4,000. *Lockwood Realty Corp.*, TCM 1958-49.

No business purpose for acquiring loss subsidiaries; can't consolidate them. Taxpayer filed consolidated returns for 1951-1953 with two wholly-owned subsidiaries, acquired in 1950, which operated FHA housing projects at a loss. The Tax Court holds that, because the acquisition lacked business purpose, there was no right to file consolidated returns (*Spreckels*, 41 BTA 370), and further that the consolidation was a benefit forbidden under Section 129 because the acquisitions had as their principal purpose the avoidance of Federal tax. The court interprets the somewhat confused factual situation as showing (1) the consideration paid for the stock of the FHA companies was nominal, the $16,000 advanced being regarded as a loan and being used to pay corporate debts, (2) taxpayer (or its alter ego, its 100% owner) had no reasonable expectation of operating the companies at a profit, (3) taxpayer did expect to operate at a profit and, therefore, to be able to use the subsidiary's losses. *Elko Realty Co.*, 29 TC No. 106.

Must eliminate intercompany net profit on consolidation, not gross. Accounting theory, and also the consolidated return regulations, require that, in preparing statements for a consolidated group, profit realized on transactions within the group be eliminated; if the profit relates to merchandise held for sale, the inventory is reduced; if it relates to equipment used in the business, the basis for depreciation is reduced. The consolidated group in this case consisted of a construction company which built housing projects for two wholly-owned subsidiaries operated by them as rental properties. The parent construction company computed its income by the completed-contract method, taking into income in any year the gross profit on projects completed, and deducting therefrom its general expenses and overhead incurred in that year. For the years in which it completed the projects for the subsidiaries, it eliminated from taxable consolidated income the entire gross profit on the projects. The Commissioner eliminated net profit. The court points out that this question is simply the reverse of the related one: what is the true cost of the projects, treating the consolidated group as one entity? Noting that the regulations do not specify how intercompany profit is to be computed, the court turns to accounting theory and concludes that the true cost of the project must include a proper allocation of overhead, i.e., it is intercompany net profit, not gross profit that must be eliminated. Conceding that, in the state of the record, its allocation must be somewhat arbitrary, the court finds the proportion of general expenses allocable to the projects and reduces the eliminated intercompany gross profit by these amounts. *Algernon Blair, Inc.*, 29 TC No. 128.

Corporation "mortgaging out" with FHA funds collapsible. Taxpayer was a principal stockholder in a corporation organized to construct an apartment project with an FHA-insured loan. It retired all of its outstanding class B stock upon completion of the project with the excess of the FHA loan over the cost of construction. A year later, taxpayer, a principal stockholder, sold all of his remaining class A stock to an outside party. It had no accumulated earnings and profits. The Tax Court held the corporation was a collapsible one within the definition of the 1950 Act (applicable to 1949 and later years) and gains realized by taxpayer from both the redemption of the class B stock in 1950, and the sale of class A stock in 1951 were ordinary income. The taxpayer argued that the language of the committee reports shows that Congress intended the collapsible rules to apply to temporary corporations, and this particular corporation is still in existence operating the apartments. The Tax Court found the statutory language clearly applies. Similarly, the argument that the committee reports refer to distributions of property, not of cash, was held invalid because the statute makes no such distinction. Also the distribution out of the mortgage in excess was a gain "attributable" to the property, as the Regulations here provide. Finally, the Tax Court concluded that taxpayer did not show his intent was other than to redeem the stock prior to realization of income. This Court affirms. *Burge*, CA-4, 3/6/58.

Distribution treated as from a collapsible corporation; burden of proof not shifted. A distribution by a construction corporation of $50,000 to a stockholder at a time when the construction was almost complete is held to have been made by a collapsible corporation, and is taxable to the recipient as ordinary income in the absence of proof that the collapsible corporation section doesn't apply. The fact that the Commissioner in his deficiency notice stated that the distribution was taxable at ordinary income tax rates and did not mention the applicability of the collapsible corporation section until actual trial did not shift the burden of proof to the Government. *Sorin*, 29 TC No. 101.

Stock attribution rules in redemption; beneficiary's interest in estate's stock measured as of redemption date. The stock attribution rules applicable to stock redemptions state that the beneficiaries of an estate will be considered as owning the estate's stock on a proportional basis. The regulations state that, if a beneficiary has received all the property due him, he will no longer be considered a beneficiary. What happens when there is a non-pro-rata distribution and the beneficiary still has an interest in the estate? What proportion of the estate's stock is he considered to own? The IRS rules that a beneficiary's interest in the estate's stock is not fixed for tax purposes by the will, but should be computed as of the date of the stock redemption to reflect any non-pro-rata distributions. *Rev. Rul.* 58-111.

TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

EDITED BY JOSEPH TRACHTMAN & J. A. MANNING

Advising the delinquent gift tax payer: practical and ethical hazards

by JOHN C. MASON

What should you say to the client who hasn't filed gift tax returns, but who has made transfers that should have been reported? Why is it to his advantage to file delinquent returns rather than rely on the slight chance of discovery? Suppose the exemptions would have covered the gift and no tax would be due? What ethical considerations bind the adviser? Mr. Mason, Lincoln, Nebraska, attorney, reviewed these extremely practical problems at a recent meeting of the Nebraska State Bar Association. This article is based on his comments there.

IT IS FAR BETTER to file a delinquent gift tax return than not to file at all. Not only does the gift tax lien pursue the donor implacably until satisfied, but it extends to his donee and can even render the beneficiary of a gift liable for gift tax owed on property given to others. It is also better to disclose in the return all transfers the status of which as taxable gifts is in doubt, because of the advantage which such evidence of good faith gives to the taxpayer. And it is the duty of the practitioner to advise his client to file such returns whenever he encounters in his practice a situation involving an unreported gift.

Typical dangerous situations

A gift is a transfer of property for less than an adequate and full consideration in money or money's worth. Thus, a transfer may constitute a gift not only where there is no consideration other than love and affection for the gift, but also where the consideration is less than adequate compared to the value of the gift itself. The adequacy of the consideration must be measured in money or money's worth, thus including as gifts transfers made for love and affection.

Transfers pursuant to antenuptial agreements, made in consideration of the release of dower and marital rights, are not considered to be transfers for adequate consideration, and therefore they are treated as gifts for gift tax purposes. Transfers made pursuant to divorce and separation may be considered transfers for an adequate consideration, however, if certain requirements are met. Generally these requirements are that the transfer be pursuant to a written agreement, and that a divorce occur within two years thereafter.

I believe it is the practitioner's duty to make inquiries whenever he suspects that there may have been transfers for less than an adequate consideration. Typical situations involving such transfers include the following, to which one can no doubt add others. The client may have transferred an interest in his business, his farm or his ranch, to his wife or his children. There may have been transfers of stock in the family corporation, or transfers of partnership interests. There may have been sales of property to the wife or children for less than an adequate price.

A property settlement incident to a separation or separate maintenance, not followed within two years by divorce, would involve a transfer which would be considered a gift.

Transfers made pursuant to antenuptial agreements are gifts.

The client may have created an inter vivos trust, or client may be the beneficiary of an inter vivos trust created by his parents or others.

Joint tenancy interests in real or personal property may have been created, in which one joint tenant did not contribute his or her share of the purchase price.

Client may have made charitable gifts, or gifts to his college or school.

Client may have paid his son's mortgage or other indebtedness. Or he may have released the indebtedness owing to him by one of his relatives. He may have created life estates or remainder interests. He may have given away some valuable life insurance policies or paid premiums on policies owned by another.

Let us then discuss the considerations which the attorney should bear in mind in advising his client what to do about a situation in which the client has made a reportable or taxable gift at some time prior to his visit to your office, but has not reported the gift.

Rules for filing, paying gift taxes

Our first inquiry is: What are the requirements for the filing of gift tax returns by donors, and what are the conditions under which donors are required to pay gift taxes on their gifts?

For a brief period in 1924 and 1925 there was a gift tax law in effect which was repealed. For practical purposes I think we need not concern ourselves with gifts made during that period. The present gift tax laws, however, originated in 1932. We are, therefore, initially concerned with any gifts made during the more than 25 years since June 6, 1932, the effective date of the first Act.

During this period it has always been required that a return must be filed by any individual who makes a gift or gifts to any one donee in any one calendar year, which gifts exceed the annual exclusion. The annual exclusion has been changed twice during this period. For the years 1932 through 1938 the annual exclusion was $5,000. The annual exclusion for the years 1939 through 1942 was $4,000, and then, beginning in 1943 and continuing to date, the annual exclusion has been $3,000. This requirement for filing a gift tax return applies to charitable donations as well as private gifts.

With respect to gifts made after April 2, 1948, married donors are given the right to have their gifts treated as having been made one-half by the donor and one-half by the donor's spouse, if the spouse consents to this arrangement. The consent must be signified on the gift tax return when filed. There are certain circumstances in which the right to split the gift may be lost, and this will be discussed later. With respect to

the question of whether a gift tax return is required in a situation in which the gifts are being split between the husband and wife, the rule is that, if without splitting the donor would be required to file a return, then he is required to file a return even though, as a result of the splitting, his share of the gift may be less than the annual exclusion. The spouse who is not the donor is not required to file a return unless his or her one half of the gift, after giving consideration to the splitting, is great enough to exceed the annual exclusion. Also, beginning in 1948, gifts by one spouse to the other may be treated as a gift of only half the value of the property.

There is one exception to the annual exclusion which should be borne in mind. That is that, if the gift is a gift of a future interest, then the gift is not entitled to the annual exclusion, and any amount of a gift of a future interest subjects the donor to the requirement of filing a gift tax return. There is an exception to this exception in the case of a gift to a minor, where the rule under the 1954 Code now is that a gift to a minor will qualify for the $3,000 gift tax exclusion if the property given and the income therefrom may be used for the minor's benefit during his minority, and if the unexpended property and the accumulated income will be distributable to the minor outright at age 21. A further requirement is that, if the minor dies before reaching age 21, the property and its accumulated income must pass to his estate.

If the gift is determined to be a reportable gift, then the donor is required to file a donor's return on Form 709. On this form he is required to list not only the gifts for the current year, but also prior taxable gifts. The instructions on Form 709 require the donor to list the "correct amount of the taxable gifts for each prior year during which gifts were made" and not merely the amounts reported on any returns made in such year. Thus, if the donor is intending to make gifts in the current year which will be reportable, but has failed to report gifts in a prior year, I believe that the Commissioner, through the instructions on the form, has required him to list the earlier gifts, and the practitioner is obligated to advise him of this fact.

There is another requirement of which you should advise your client, and that is a record-keeping requirement imposed by regulation of the Commissioner. Pursuant to this regulation, every individual shall, for the purpose of determining the total amount of his gifts, keep such permanent books of account or records as are necessary to establish the amount of his total gifts, together with the deductions allowable in determining the amout of his net gifts and such other information as is required to be shown in a gift tax return.

Liability for payment

In computing gift tax liability, only the amount of gifts in excess of the annual exclusions is taken into consideration. From these amounts are deducted charitable gifts and any amount of the donor's specific exemption which is still available to him and which is claimed by him on the gift tax return. Originally the specific exemption, also referred to as the lifetime exemption, was $50,000 for the years 1932 through 1935. For the years 1936 through 1942 the specific exemption was $40,000, and for 1943 and subsequent years the exemption is $30,000. The gift tax liability is computed on the basis of all taxable gifts made at any time by the taxpayer, including those made in the calendar year for which the return is filed, from which is deducted the amount of tax computed on the basis of gifts made in prior years, except that no greater specific exemption can be claimed than that in force for the year in question.

If taxable gifts were made in a prior year on which tax should have been paid, the date for payment of the tax is the date when the return was supposed to be filed, that is, March 15 for years up to and including 1954 and April 15 thereafter. The tax is therefore delinquent from that date.

Obligations of the donee

In addition to the donor's return, a return is required of the donee who receives a gift or gifts in excess of the annual exclusion, and this return is Form 710. This requirement does not apply to the donee of a charitable gift, but does apply to all other donees.

The law and the regulations impose a personal liability for the tax on the donor. They also impose personal liability on the donee of any gift for payment of the donor's gift taxes, if the gift taxes were not paid by the donor when due, and the donee's liability is limited only by the value of his gift. It is not limited to the tax attributable to his gift. In fact the donee has been held to be liable for the donor's gift taxes due as the result of gifts to other donees during the year, even though the gift to the donee was free of tax. Furthermore, the liability of the donee is a direct liability, and it is held that he is not entitled to reimbursement from the donor for gift taxes the donee is required to pay.

The beneficiary of a trust is liable for the donor's gift taxes owing in a year when gifts were made to the trust, the beneficiary's liability being limited to the value of the beneficiary's interest in the trust resulting from the gift.

Section 6324 of the Code provides that the tax due as a result of the donor's gifts for the calendar year is a lien, which lien continues for ten years from the time the gifts are made. Thus, the donee received the property subject to a lien for any gift taxes owing by the donor for gifts made during the year, and the lien is not limited to the portion of the gift tax allocable to the gift which the particular donee has received. If the tax is not paid when due, then the donee becomes personally liable for the tax to the extent of the value of the gift which he has received. If the donee transfers the property to a bona fide purchaser or mortgagee for an adequate consideration, then the property which was the subject of the gift is divested of the lien, but the lien to the extent of the value of the gift attaches to all of the other property of the donee, including after-acquired property. Thus, the donee has personal liability, and has a lien on the gift property, and in the event of the transfer of the gift property, he has a lien on all of his property for the amount of the tax limited by the value of the gift.

The donee, therefore, has a real incentive to ascertain that the donor files a proper return and pays the tax.

If the donee is a trustee, the beneficiaries of the trust become liable for the tax to the extent of their interest as beneficiaries of the trust in the gift made to the trustee.

This special lien statute, Section 6324, imposes a lien upon the donee and the donee's property. The general lien statute, Section 6321, imposes a lien on all of the property of the persons liable to pay any tax, which therefore would include the donor and the donee, if such person neglects or refuses to pay the tax after demand. Therefore the lien for gift taxes applies to the donee immediately, but does not apply to the donor until demand for payment is made.

Section 6901, dealing with transferred assets, provides that, for assessment, collection and limitations purposes, a donee is treated as a transferee. The period of limitations for assessment of liability on a transferee is one year after the expiration of the period of limitations for assessment against the transferor. Thus, if the limitations period for the donor is three years, the limitations period for the donee is four years. If the liability extends under the transferee provisions to a transferee of the donee, then an additional year is applicable, etc., except that the maximum limitations on transferees of transferees is three additional years.

Therefore, to advise your client properly, you must analyze whether or not the limitations period may have run, not only on criminal penalties, but also on assessment of the tax. If he fails to file a return, he is never free from the possibility of liability. If your client is the donor and has filed a return and the three years have expired, then he is probably in the clear, in the absence of fraud, but his donee may still be subjected to paying a deficiency, if the donee's limitations period has not expired.

Obligations of an executor

In addition to the requirement that the executor file any gift tax return which the decedent failed to file during his lifetime, there is a requirement that, where a Federal estate tax return must be filed, certain questions must be answered by the executor on the estate tax return Form 706 which pertain to gifts made by the decedent during his lifetime. These questions appear on Schedule G. The executor is asked to state whether the decedent made any transfers within the general categories which would require them to be includible for estate tax purposes, such as transfers made in contemplation of death, transfers taking effect at death, etc., and whether the decedent at any time made any gifts of $5,000 or more which are not believed to be includible in the gross estate. If the question is answered "yes," details must be listed. Next the executor is asked whether any transfers at all were made within three years immediately preceding the death of the decedent, and if any such transfers were of amount of $1,000 or more, details must be furnished. The executor is also asked whether the decedent had created any trust during his lifetime.

These questions place a broad obligation on the executor to inquire into the gifts which may have been made at any time by the decedent, and disclose them to the Commissioner.

Thus, we see that the donor, the donees and the executor or administrator or guardian of the donor or donee may be in trouble if they fail to file returns, if they fail to keep records in accordance with the requirements of the regulations and particularly, of course, if they fail to pay taxes which are due.

What penalties may accrue to the taxpayer upon failure to file a return and pay the gift tax due? In the first place, interest at the rate of 6% per annum shall be paid from the time when the tax was due until the tax is paid. For failure to file a return on the date prescribed therefor, Section 6651 provides for a penalty of 5% of the amount of the tax for each month of delinquency, with a maximum of 25%, unless it is shown that the failure to file a return is due to reasonable cause and not to willful neglect. Apparently if there is a failure to file, but there was no tax due in any event, this provision would not result in a penalty. It has been held by the Board of Tax Appeals in one case that the lack of familiarity with the law on the part of the administratrix, plus reliance upon the advice of an attorney who contended that a return was not necessary under the circumstances, constituted reasonable cause, and no penalty was assessed. (*McColgan,* 10 BTA 958). On the other hand, it has been held by the Sixth Circuit that ignorance of the law is no excuse for failure to file a timely return. (*Cronin,* 164 F.2d 561).

Why file returns late?

Even one day of delinquency can result in the assessment of a 5% penalty.

The penalties for failure to pay the tax when due are, of course, more serious. It is provided in Sec. 6653 that, if any part of the underpayment is due to negligence or intentional disregard of the rules and regulations, there shall be added a penalty equal to 5% of the underpayment. It is further provided that, if any part of the underpayment is due to fraud, there shall be added to the tax as a penalty an amount equal to 50% of the underpayment. It is further provided that, if a penalty is assessed under this section for fraud, then no penalty is to be assessed under Section 6651 for failure to file a return, in order to avoid adding the penalty for failure to file a return to the penalty for failure to pay the tax. Section 6653 provides that an underpayment of tax is the difference between the tax actually due and the tax shown as due on the return. Thus in the case of late filing the entire tax due will be considered the underpayment. This is another incentive for filing the returns on time.

Section 6659 provides that the additions to tax and penalties become a part of the tax, which therefore subjects the donee to liability for the penalties resulting from the donor's failure to file a return or pay the tax.

Right to split

Leaving the area of liens and penalties, I would like to suggest a few miscellaneous points for consideration with respect to the problems which might result from failure to file returns or failure to pay tax. One of the important benefits granted to taxpayers with respect to gifts made after April 2, 1948, was the right to have the gift of a spouse treated as a gift by both husband and wife, and split between them, if they both consented to the splitting. However, certain formalities must be complied with in order to be certain of this privilege.

Section 2513 provides that, in order for the splitting to be effective, both husband and wife must consent to this special treatment as to all gifts made during the calendar year by either of them. The consent may be signified at any time after the close of the calendar year, except that it may not be signified after April 15, the due date of the return, if the husband and wife had filed returns before that date without signifying such consent. If neither files a return before the due date, the consent may be signified at any time up to the time when either of them files a return. However, there is one further exception, and that is that the consent may not be signified after a notice of deficiency has been sent to either spouse.

In other words, if you do not urge your client to file a return as soon as the delinquency is discovered, it is possible that the Government will discover the delinquency also, and if they send a notice of deficiency, then your client will no longer be able to claim the splitting advantage. This is another reason for not delaying in the filing of a return after you have discovered that there is a delinquency.

There is one additional advantage to filing a return where there will be a gift

tax owing, and that is that under Section 2504, if a return has been filed with respect to gifts for a preceding year, if any tax has been paid in connection with the return for that year, and if the time has expired for assessment of the tax, then the value of the gift as returned cannot be questioned by the Government in connection with the computation of taxes for 1955 and subsequent years. This could be quite important where, for example, a client is making periodic gifts of stock in his family business. If the gifts are great enough that they result in even one dollar of tax, the valuations become final after the limitations period has run.

Fixing value

Where, however, he limits his gifts to amounts which do not quite require payment of tax, then the Government might, in the audit of a gift tax return involving current gifts, be able to go back for a period of many years and claim that his ideas of the value of the gifts made in previous years were quite inadequate and assess a tax and penalties which might be severe.

This suggests the possibility that it might be to the advantage of your client in some cases not to claim all of his specific exemption in connection with gifts for a particular year, but claim only enough to reduce the tax to a minimum amount, so that there will be some tax on the gift. Or if he has already used up his specific exemption, it might be well to have him make gifts which are slightly over the annual exclusion instead of slightly under the annual exclusion in order to commence the running of the statute of limitations on valuations claimed by the client.

Investigating the estate

There is one other practical reason for advising a client against failing to file returns on gifts made in prior years. Because of the requirements that the executor disclose gifts made in prior years, there is some likelihood that the Government will eventually catch up with the client. He no doubt will have some records and some memory as to the dates and values of gifts made in previous years, and the tracing of the funds which were used to purchase the property which was the subject of gifts. It might be a very practical advantage to have these facts accumulated, analyzed and reported in gift tax returns during the client's lifetime, rather than waiting until after his death when the facts may not be so easy to ascertain.

Limitations

We should now examine the limitations applicable to civil sanctions. Section 6501 imposes a limitation on assessments and collection of tax. The assessment shall be made within three years after the return was filed, and no proceeding in court without assessment for the collection of the tax shall be begun after the expiration of the period. The return, if filed, is deemed to be filed on the last date when it could have been filed. In other words, the March 15 and April 15 dates are applicable in the case of gift tax returns.

However, there are exceptions extending the limitations period in the following cases: a fraudulent return with intent to evade tax, a willful attempt to defeat or evade the tax and failure to file a return. Thus, if your client for any reason has failed to file his return, there is no limitation applicable.

Finally, if the taxpayer omits items which should have been included as gifts for the year, which items exceed 25% of the total amount of gifts stated in the return, the limitations period is extended to six years.

In this connection, if there is any doubt as to whether an item should be included in the return, it is advisable to disclose it in the return, even though it is not listed as a taxable gift, because in determining the items omitted from the total gifts under this provision, there shall not be taken into account any item which is disclosed in the return, even though it is not listed among the total gifts stated in the return. Thus, by advising the Secretary of the existence of a transfer, the three-year limitations period is preserved.

I would like to wind up this discussion with some comment on the lawyer's ethical responsibility in this field of discovering the client's delinquencies, advising the client about the gift tax requirements, and particularly the responsibility of recommending a course of action for the client to follow. Attorneys, engaged in any tax practice are not only subject to the canons of ethics of the Bar Association, but also the regulations governing enrollment and practice before the Treasury Department.

Ethical considerations

The regulations issued pursuant to statutory authority are contained in Circular 230. Section 10.2(c) provides that each enrolled attorney or agent who knows that a client has not complied with the law or has made an error in, or an omission from any return, document, affidavit or other paper which the law requires such client to execute shall advise his client promptly of the fact of such non-compliance, error or omission. Sub-paragraph (g) provides that every claim, affidavit, written argument, brief or statement of fact prepared or filed by the enrolled attorney or agent in any matter pending before the Treasury Department shall have affixed thereto a statement signed by such attorney or agent showing whether he prepared such document and whether he knows of his own knowledge that the statements and facts contained therein are true.

Section 10.10(b), dealing with disreputable conduct, sets forth certain acts which are deemed to constitute disreputable conduct and therefore subject the attorney to disbarment from practice before the Treasury Department. These include preparing or filing for himself or another a false Federal income tax return or other statement on which Federal taxes may be based, knowing the same to be false. They include suggesting to a client or prospective client an illegal plan for evading payment of Federal taxes, knowing the same to be illegal. They cover the giving, with intent to deceive, of false or misleading information relative to a matter pending before the Treasury Department to any officer or agent of that department.

It seems to me that, as officers of the court, as attorneys enrolled to practice before the Treasury Department, and as ministers of the law, it is our duty not only to point out to our clients the requirements of the statutes and regulations, but that in addition we have the duty to counsel and advise our clients to comply with those laws and regulations, to make the necessary filings and pay the necessary taxes whenever facts are brought within our knowledge indicating that a noncompliance may exist. For the most part, I believe that our clients come to us to advise them on how to comply with the law and keep out of trouble, rather than for advice on how to evade the law and escape the trouble. Even though there is little likelihood of penalties in a case where no tax could be due, it seems to me that we should advise our clients to file gift tax returns as required by law. Certainly, in cases where taxes should have been paid,

and therefore penalties and interest are likely, it is our clear duty to advise the client to file the return and pay the tax. If after such explanations, disclosures and recommendations have been made, the client persists in refusing to file the return or pay the tax, then at least you will have discharged your responsibility.

Pitfalls in the family trust: warning on a few unsolved problems

WHILE THE PROPOSED estate and gift tax regulations make few changes from the old, a study of their provisions does reveal some areas that are probably going to cause difficulty. At a meeting of the Federal Bar Association in New York recently, Sydney C. Winton, New York attorney, briefly reviewed some of these problems in connection with charitable gifts of stock in a close corporation, basis problems in 10-year trusts and, finally, the interrelation of support trusts and separation agreements.

"The estate planner must exercise caution," Mr. Winton said, "in making charitable gifts in trust where the subject matter is the stock of a close corporation. The proposed regulations[1] provide that a limited interest, such as a life estate or a term of years, is to be valued actuarially, capitalizing the expected income. This is done on the basis of assumed income at 3.5%. Since the amount of charitable deduction is in effect a capitalization of this assumed income at 3.5%, the trust and surrounding circumstances should provide assurance that income will in fact be realized. Identical provisions to this effect are now contained in both the proposed gift[2] and estate tax[3] regulations. The regulations provide[4] that:

" 'The [charitable.—*Ed.*] deduction is not allowed in the case of a transfer in trust conveying a present interest in income if by reason of all the conditions and circumstances surrounding the transfer it appears that the charity may not receive the beneficial enjoyment of the interest. For example, assume that assets placed in trust consist of stock in a corporation controlled by the decedent and his family, that the trustees and remaindermen are likewise members of the decedent's family, and that the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees were not members of the decedent's family but had no power to sell or otherwise dispose of the closely held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, no deduction will be allowed.'

"Even if there is an outright gift (i.e., not in trust), care must be taken that the provisions of the stock itself are definite. This is pointed out by the decision in *Overton*, 6 TC 304, *aff'd.* 162 F.2d 155, where husbands made gifts to their wives of non-voting stock which had a value of only $1 a share on dissolution. Dividends were discretionary and were to be paid one-fifth to voting stock owned by the husbands and the balance to non-voting stock. It was held that the gifts would arise when and if dividends were paid on non-voting stock.

"One further word should be said with regard to gifts of preferred stock. In many instances, such stock will be Section 306 stock. I have heard it said that a redemption of Section 306 stock within a year or so of its gift to a charitable foundation is claimed by the Treasury to be income to the donor on the theory that it is a step transaction." [See the discussion of the Treasury attitude on 306 stock held by foundations at 7 JTAX 62.—*Ed.*]

Basis problems in 10-year trusts

The codification of the Clifford rules in the 1954 Code makes it possible to use a trust with a term in excess of 10 years to divert income from the grantor.[5] A problem often overlooked in the use of such trusts is the uncertainty of the basis of the trust corpus (which reverts to the grantor after the expiration of the more-than-10-year term) if the grantor dies within the 10-year period. The remainder, which would often encompass the bulk of the value of the trust corpus, would be includible in the grantor's estate. What effect does this have upon the basis of the stock in the trust?

Under the proposed regulations it would appear that the stock would have a basis equal to the grantor's original basis. However, if the stock is held until the termination of the trust and turned over to the remainderman, the remainderman would get a partially new basis.[6] This new basis would be determined by subtracting from the trust's original basis (usually the decedent's cost) the decedent's actuarial share of this basis at the time of his death, and adding thereto the amount included in the decedent's estate as the actuarial value of his remainder interest.[7]

If in a particular case you wish to avoid this possibility, you may, if the grantor's life expectancy is over 10 years, provide for the termination of the 10-year trust on the earlier death of the grantor. Such a trust is deemed a trust for over 10 years under the income tax regulations.[8]

Support trusts, separation agreements

This is a rather involved topic. If you have a support trust, you have your hands full of technical tax problems. In general, the income tax regulations[9] now provide that, if a person is obligated to support a dependent, he is the real beneficiary of the trust if the income is used for the support of the dependent and he is, therefore, taxable on the income so used. This is apart from taxability based on a *power* to use the income of the trust for the support of one's dependent.[10]

Under the proposed gift tax regulations, a trust for the support of one's legal dependent is stated to be for insufficient consideration and its creation is presumably a taxable gift[11] unless, under local law, the transfer operates completely to discharge the donor's legal obligation.

Nevertheless, it would seem that, even if this is not the local law, there would

[1] The proposed gift tax regulations were published in the Federal Register on January 3, 1957, starting at p. 53; the proposed estate tax regulations were published in the Federal Register of October 16, 1956, starting at p. 7849.
[2] Reg. 25,2522(a)-2(b).
[3] Reg. 20.2055-2(b).
[4] Old.
[5] IRC Secs. 673(a), 674(b)(2), 676(b).
[6] Reg. 1.1014-6(b)(3).
[7] Id.
[8] Reg. 1.673(a)-1(c).
[9] Reg. 1.677(b)-1; Reg. 1.678(c)-1.
[10] See IRC Sec. 677(a) and IRC Sec. 678(a).
[11] Reg. 25.2512-8.
[12] Reg. 20.2043-1(b); see also Helvering v. McCormack, 135 F.2d 294.
[13] Gornick, *"How Divorce and Separation Affect Estate Taxes,"* J. K. Lasser's Estate Tax Techniques, pp. 88-89.
[14] Reg. 20.2043-1(b); 25.2516-1(c).
[15] Harris v. Comm'r, 340 U.S. 106.
[16] E.g., Comm'r v. Watson's Estate, 216 F.2d 941; McMurtry v. Comm'r, 203 F.2d 659.
[17] Reg. 20.2043-1(b).
[18] Reg. 20.2053-4(b).
[19] See Loughlin's Estate v. Comm'r, 167 F.2d 828.
[20] Reg. 20.2053-4(b).
[21] Reg. 25.2516-1(c).
[22] McMurtry v. Comm'r. *supra*, note 16.

be no taxable gift to the extent of the support right since the right to have the income used to discharge the grantor's support obligation would be pro tanto a reserved interest for the benefit of the grantor. This appears inferentially from the estate tax regulations[12] where such a transfer is subjected to estate tax, it being there said:

"The decedent's obligation is discharged *pro tanto* as each payment for support is made and not by the original transfer. Therefore, for example, property transferred in trust for the support of a dependent is includible in the decedent's gross estate under 2036(a)(1) . . . since in such case the decedent retained the benefit of the property or its income during his life."

With respect to transfers for support in a marital settlement followed by divorce within two years, the gift tax consequences are taken care of by Section 2516 of the Code, which provides that a transfer to provide a reasonable allowance for the support of the spouse and minor children is deemed to be for full consideration. This section is apparently not applicable to estate tax, although some question as to that has been raised by some well-informed commentators.[13]

The proposed gift and estate regulations[14] attempt to codify the *Harris* case[15] and related cases[16] that found no taxable gift in court-approved marital property splits. The estate tax regulations[17] provide that, if the transfer is made to carry out a court decree in a divorce, separation or annulment proceeding, (or, if made in advance of such a decree, is later incorporated or approved therein or is contingent thereon), the amount includible in the decedent's estate is reduced by the value at decedent's death of the beneficiary's continuing right of support as fixed or approved by the court.

The above rule applies to transfers. If there is a separation agreement with only a personal obligation to make support payments to continue after the decedent's death, payments accruing after decedent's death, if the separation agreement was not embodied or approved in a divorce or similar decree, would not be allowable as claims against the estate.[18] Presumably, payments made under the agreement would be allowed as distributions to the recipient under Section 682.[19]

If, however, the agreement is embodied in a divorce decree or is approved therein or contingent thereon, the regulations state it would be allowable as a claim against the estate.[20]

With respect to gift taxes, however, the regulations[21] are worded somewhat differently. If there is no divorce decree within two years after the separation agreement, it would seem that so much of the property as is transferred for marital rights other than for the support of the wife and minor children would be subject to gift tax. The wording of the gift regulations would seem to indicate that, if the decree is entered more than two years after the separation agreement, then it will not obviate the gift tax upon the separation agreement unless the agreement was to become binding only upon the entry of the decree. This seems to be a departure from the *Harris* line of cases, particularly *McMurtry*.[22] ☆

New estate & gift decisions this month

Gift of remainder in unproductive property is its full value. The taxpayer transferred real property valued at $66,000, to a trust, retaining to herself the power to receive as much of the income therefrom as she might require, the corpus and any accumulated income to be divided upon her death among her four daughters. The land was unimproved and produced no income. The donor required her daughters to execute promissory notes, totaling $12,000, on the date of the transfer. The value of the retained discretionary right to receive income was not deductible from the value of the land, since, the property being non-income producing, no value could be assigned to it. The taking back of promissory notes was a mere subterfuge, intended to establish consideration, a conclusion evidenced by their prompt cancellation. Since the gifts were of future interests, not to take effect until the donor's death, they do not qualify for the $3,000 annual exclusion. *Deal,* 29 TC No. 81, 1/29/58.

Prior return by wife does not bar later one splitting gifts [*Acquiescence*]. Taxpayer's wife had filed a gift tax return, prepared for her by her son by her first marriage, reporting gifts which she had made during the year but prior to her marriage to the petitioner. On the taxpayer's own gift tax return, she consented to be considered as making one-half of the gifts made by the taxpayer. The wife's consent was timely signified on his return, since the earlier return filed in the wife's name did not relate to gifts by a "spouse" and could not have misled the Commissioner, *Frieder,* 28 TC 1256, *acq.* IRB 1958-7.

Commissioner's valuation of mineral interests is upheld. Taxpayers transferred to their children an undivided one-half interest in the gas, oil and other mineral rights in 8,000 acres of land. As to 3,000 acres of the land conveyed, the interest of the donors extended only to a ⅛ royalty interest, the land having been theretofore leased. One week after the gift, the remaining 5,000 acres were leased, the donors and donees retaining a ⅛ royalty interest, and the lessees paying $20 per acre for the remaining ⅞ interest. The Commissioner's determination of the total value of the mineral rights: $20 per acre with respect to the land already leased at the time of the gift, and $40 per acre for the as yet unleased land, is upheld by the court in the absence of a showing of error. *Mills,* TCM 1958-26.

Interest in farm was for life only; not includible in estate. The Commissioner included in decedent's estate a ⅓ interest in an Iowa farm (valued at $400,000) on the ground that she had inherited a ⅓ fee interest on the death of her husband. The husband's will had been ambiguous, but as the result of an uncontested construction proceedings, decedent, as the widow, had accepted a share of income. Turning to Iowa law, the Tax Court finds the intent of the husband in referring to a "dower" interest remaining in his widow had intended to give her only a life interest. It follows that the value of this property is not includible in her estate. *Adams Estate,* TCM 1957-246.

Tax Court values apartment [*Acquiescence*]. Taxpayer estate reported its apartment building at $200,000; the Commissioner asserted $225,000, which he raised to $255,000 in the Tax Court. The court finds the value $215,000. *Tarver Estate,* 26 TC 490, *Acq.* IRB 1958-7.

Beneficiary of wholly discretionary trust made no gift of interest. The Commis-

Notes on new estate and gift decisions in this department are by Edward P. Hannigan, member of the New Jersey Bar and associated with Harrison F. Durand in Newark.

sioner asserted that taxpayer here made a gift when part of the corpus of a trust in which income and corpus could be paid to him, but wholly at the discretion of an advisory committee, was transferred to another similar trust from which all the income and corpus could, in the discretion of the committee, be paid to his wife. The first trust, created by taxpayer's father, would allow only ⅓ of the income to be paid to the wife, and taxpayer had long urged a distribution of corpus to him to permit him to make better provision for his wife. However, the Tax Court says flatly that, in the direct transfer from one trust to another, taxpayer made no gift—he had no interest he could give. It notes that, before creating the new trust, the advisory committee had secured the consent of taxpayer's sister, a contingent beneficiary in whatever property might be left at taxpayer's death, and says it believes, although it does not here decide, that she was the one who made the gift. *Hazelton,* 29 TC No. 70.

Transfers primarily to reduce income taxes not in contemplation of death. Decedent, at that time aged 76, made gifts of four parcels of real estate to his children. He had been involved a short time previously in an income tax controversy with the IRS and paid a large deficiency. He sought legal counsel as to methods of reducing his income tax liability, and the transfers of the income-producing property were the direct result of the attorney's advice. The attorney never discussed the estate tax aspects of the transfer with the decedent, limiting himself to the question of income tax savings. The decedent was in very good health at the time of the transfers. Despite the fact that the pattern of gifts followed very closely that set out in the decedent's existing will, the court finds that the gifts were not made in contemplation of death. The decedent's health was good and income tax savings his prime, if not sole, motivation in making the gifts. *Ackel Est.,* TCM 1958-27.

Relief for transfers at death doesn't help one with retained life interest [*Certiorari denied*]. Decedent purchased two single-premium annuity contracts under which she was to receive an annuity during her lifetime and, upon her death, her daughter was to receive an annuity for her life. The circuit court held that the value of each policy was includible in the decedent's gross estate as a transfer with a retained life interest. The fact that the transfers might also be considered as intended to take effect in enjoyment after decedent's death, and, under such classification, would be free of tax because of the relief provisions of the Technical Changes Act of 1949, did not affect their includibility as transfers with a reserved life estate. *Arms Est. (Forster, Ex'r), Cert. den.* 3/17/58.

Widower's elective share under Ohio law computed after death taxes. A surviving husband renounced the will and elected his statutory one-half share under the Ohio law of descent and distribution. Taxpayer-estate argued that the share going to the husband should not be reduced by any Federal estate tax. Noting the conflict in Ohio cases on whether a surviving spouse's share, eligible for marital deduction, should bear Federal tax, and turning to the latest decision of the Ohio Supreme Court, the Tax Court held that the statutory share is computed after deducting Federal estate tax from the value of the estate. This computation of the value passing to the husband under Ohio law determines the marital deduction allowable. This court affirms without opinion. *Jaeger Est.,* CA-6, 2/19/58.

Quotations of listed securities of comparable company relied upon in valuing Luckenbach stock. The Commissioner had determined a $10,900,000 deficiency in the petitioner's estate tax based upon his valuation of 52,282½ shares of Luckenbach Steamship Company, Inc., included in the decedent's gross estate. In fixing a valuation, the court considered many factors, but especially the price-earnings ratio of a listed company closely comparable to Luckenbach, as well as the net asset value of the two companies. Litigation among the beneficiaries and heirs as to their respective interests was also considered to have had a slight depressant effect upon the stocks' value. After considering the entire record, the court arrived at a figure of $175. per share on the optional valuation date elected by the executor. The Commissioner's valuation had been close to $300. a share. *Luckenbach Est.,* TCM 1958-38.

Deceased partner's estate includes share of post-death earnings. Decedent had been a member of a law partnership, to which he had made no capital contribution and which owned no significant tangible property. Under the partnership agreement, the decedent's estate, in addition to other payments, was entitled for a specified period to a share of the profits attributable to work in process at the time of his death and to matters commenced and completed after the date of his death. It also provided that the decedent was to have no interest in the partnership property. The question before the court is the includibility in the decedent's gross estate of the stipulated value of the right to share in post-death earnings. The Tax Court had held that the right to such amounts represented a chose in action passing from the decedent to his estate, not dependent upon a continuance of the partnership relation and requiring no action upon the part of the estate for its collection, and that consequently its value was includible. This court affrms, making the further point that the payments constituted "income in respect of a decedent," and, as such were includible in the decedent's gross estate by implication from the pertinent income tax provisions, which provide for a deduction for estate taxes paid. [Section 753 of the partnership provisions of the 1954 Code provides that a distributive share of future income in liquidation of the deceased partner's interest, as definited in Section 736(a), shall be considered income in respect of a decedent. It was apparently contemplated that such amounts would be included in the deceased partner's gross estate.—*Ed.*] *Riegelman Est.,* CA-2 3/10/58.

Annual exclusion allowed for gifts in trust for infant beneficiaries. Taxpayer made gifts in trust to each of five minor beneficiaries, the oldest of whom was 15 years of age and the youngest one year. On the basis of a finding that the trust agreements provided that the beneficiaries should have the immediate use and possession of the trust estate and could demand all of the amounts in the trust at any time, the district court concludes that the gifts qualify for the annual exclusion. No other facts are reported. *Freed,* D. C. Utah, 3/18/58.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

Experts oppose Federal extension of unemployment benefits: called "dole"

IN MARCH THE HOUSE Ways and Means Committee held open hearings on various proposals for extending unemployment insurance benefits. Some 300 requests to testify were submitted to the committee, but since the hearings were limited to three days, only a small proportion of the requests could be granted.

Basically the hearings were devoted to consideration of two bills: (1) the Administration Bill which would extend the duration of benefits in the various states by 50%, and (2) the Mills Bill which would not only extend the duration of benefits by a uniform 16 weeks but also provide that benefits be increased to 50% of the claimant's pay with the maximum being set at ⅔ of the average wage in the state.

Secretary of Labor James P. Mitchell presented the administration's program. He said, in part, "The program is designed to fit in with the existing state systems without problems of adjustment. It would neither impose any Federal standard on the states nor change in any way the standards that the states have set in their unemployment compensation laws with respect to weekly benefit amount, eligibility or disqualification. Nor would it change the duration of regular benefits provided under the state law. Rather, it would temporarily provide additional benefits for those who have exhausted their rights under state or Federal laws."

Your editor appeared in opposition to both proposals as a representative of the Commerce and Industry Association of New York. Specifically as to the administration proposals, he stated: "Certainly the Federal Government does not have $600 million in spare cash available. In the vast majority of states unemployment is not a problem, and the states' funds themselves, comprising some $8.5 billion in the aggregate, are not in danger of liquidation. Certainly there are a few states in serious condition, but for the present it is our feeling that the monies available from the revolving fund set up under the Reed Bill are sufficient. If additional funds are necessary, the monies could be made available to the states on a loan fund basis but only to those states desiring to use such funds.

"The administration proposal, while 'permitting' states to contract for funds, nevertheless, gives the Secretary of Labor authority to make payments through Federal agencies in those states which do not contract for funds. While the authority of the Secretary of Labor would at first blush appear to be permissive, from a practical standpoint it would seem that action by the Secretary of Labor would almost become mandatory.

"To the extent that this proposal tends to force states into action and in the absence of state action would force benefits on the citizens of the state through Federal agencies, we find this measure to be an intrusion on the states rights which have long been the proud bulwark of our democracy."

Nelson H. Cruikshank, Director, Department of Social Security, American Federation of Labor and Congress of Industrial Organizations, presented a lengthy statement in support of Federal action, stating in part: "It is clear that the need for supplementation of unemployment benefits is present, and that it is not practical to wait longer for the states to act. It is also clear that, if Federal action stopped at the point of appropriating funds and providing for the distribution of benefits at the levels and under the conditions of eligibility now set up in state programs, it would have certain damaging effects on the future soundness of the Federal-state program. The Federal Government is now contemplating action because it recognizes the inadequacy of the state laws, and it is therefore essential that it should, at the same time, tie into whatever action it takes legislation which would shore up the state systems so that the Federal Government will not have to step in again each time a future recession threatens."

The greater majority of witnesses opposed Federal action. Here are some interesting quotes from their testimony:

Frank B. Cliffe, Vice President of H. J. Heinz Company and representing the Chamber of Commerce of the United States—"Forty-seven states could pay benefits at their current rate for a year or more before exhausting their reserve accounts. Forty-four could continue their current benefits for two or more years, 23 for four years or more and one—Louisiana—for 38 years.

"The proposals would discourage state efforts to improve their benefit laws because of the expectation of Federal aid.

"They would establish a new program of Federal relief without a needs test, setting a precedent for other social insurance programs and for public assistance."

Gayle Windsor, Jr., Member of the Arkansas Legislature and representing Associated Industries of Arkansas, Inc., and the Arkansas State Chamber of Commerce—"It happens that unemployment in Arkansas has not been critical. However, my opposition to Federal aid is not based on whether we need it in my state. I object on grounds of principle—if and when our people need more benefits, and a longer duration of payment, the legislature of the state of Arkansas can provide for the needs of our people. Furthermore, we can do it better! In 1957, we had a special session which lasted only three days and cost slightly more than $18,000. Can you match that in Congress? If our need required it, we could meet and be paying extended benefits 10 days from now. I have publicly called for a special session of our legislature, should our economic condition justify it."

William B. Hubbard, President, Inter-Association Unemployment Insurance Committee—"This program was conceived in 1935 as an insurance system designed to meet a certain limited risk. It was not to be a cure for a depression, but rather as a 'first line of defense' to insure part of the loss of wages involved. For 23 years now the theory has been maintained by the states that this benefit level should not be so high as to

remove the incentive for a continued and vigorous search for work, nor should they be paid so long as to cause a worker permanently to readjust his standard of living in order to subsist on benefits rather than forcefully to take steps to achieve personal economic rehabilitation."

R. T. Compton, National Association of Manufacturers—"There is another area in which we are woefully short of statistics. The country has never been supplied with any national figures showing what happens to beneficiaries when they stop receiving benefits. For example, in January one and a half million people discontinued making unemployment benefit claims. Of these about 10% ceased filing claims because of exhaustion of their coverage. As to the other 90%, we have no information whatever. We can only guess. We may presume, I suppose, that the majority of them found jobs. We may presume also that a large number left the labor market by reason of death, illness, marriage, the desire to go to school, being tired of work, or countless other reasons known only to themselves.

"Our figures do not show what happens to people *after* they exhaust benefits. They may continue to hunt for work; they may find work; they may retire from the labor market; they may marry or they may go back to school. If a man finds a job for a period and then draws benefits again, he goes back into the statistics again and adds another 'exhaustee' to the total.

"Many of those who exhausted their benefits in January of this year undoubtedly went back to work in February or March, but they will continue to be carried in the totals for the year. For there are no figures showing how many of those who have exhausted their benefits have gone back to work—or when."

Norris W. Ford, Executive Vice President, the Manufacturers Association of Connecticut, Inc.—"The problem of unemployment is essentially a matter which must be handled on a local basis. The economies of no two states are alike. Some are essentially farm states; others like Connecticut are primarily industrial states. It is for this reason that the unemployment systems have been established on a state-by-state basis. The proposal to standardize the treatment of essentially different problems, which is the essence of Federal intervention, is, therefore, unworkable and could only result in undermining the existing systems."

Otto F. Christenson, Executive Vice President, Minnesota Employers Association—"None of these proposals will create any new dollars. They will simply transfer dollars from the pockets of the taxpayers, or the customers of industry and business, to a selected group of unemployed. No additional dollars would be created in the process and no additional purchasing power would be created.

"Again we are hearing the arguments that we should spend ourselves into prosperity. Forgotten now is the lesson of the 1930's:

Year	*Unemployed*	*% of labor force*
1931	8,000,000	26
1932	12,000,000	23
1933	13,000,000	26
1934	11,000,000	21
1935	11,000,000	21
1936	9,000,000	17
1937	8,000,000	14
1938	10,000,000	19
1939	9,000,000	17

"But now, in 1958, there are about five million unemployed — constituting only 7% of the labor force.

"Members of the committee, I am utterly baffled by the current proposals that we must now, because 7% of the labor force is unemployed, depart from our established unemployment compensation system. Putting it bluntly, you are being asked to corrupt the basic principle of unemployment compensation and risk destroying the program for all time. It is extremely important that the unemployment compensation program be preserved as a protection to employees for years to come. This much needed protection will be weakened and conceivably eliminated if the present program is converted and perverted into a relief system to deal with the recession of 1958."

Marion Williamson, Director, Employment Security Agency, Georgia Department of Labor—"England in 1920 and 1921, during the post-war depression, followed the course of providing so-called extended benefits, i.e., beyond 26 weeks on a governmentally financed basis. The period of extended benefits was progressively lengthened. Finally, the actuarial concepts of the program broke down altogether and the concept of payment as a matter of right went out the window, too. Extended benefits were then administered on a needs basis. Thus, the 'dole' system."

A few states appeared in support of the legislation. Among them were Michigan and Pennsylvania. Mr. William J. Batt, Jr., Secretary, Labor and Industry, representing the Commonwealth of Pennsylvania, stated—"The situation in Pennsylvania may be summarized as follows:

"1. There is need for additional benefits for a substantial number of workers who have already exhausted their benefit rights in this present national recession;

"2. Financial aid will be necessary to deal with this problem, since the Unemployment Compensation Trust Fund of this state is not now in a position to assume any added cost burden. Since it is a national recession, we believe the costs should be shared nationally through direct Federal grants." ☆

Kentucky weekly unemployment benefits increased

EFFECTIVE WITH benefit years beginning on and after April 1, 1958, the maximum Kentucky weekly benefit payable to an unemployed worker was raised from $32 to $34, with the minimum going up from $8 to $10.

At the same time, the minimum period of disqualification for the voluntary leaving of employment without good cause or discharge for misconduct was increased from one week to six weeks.

Employers' contribution rates, beginning with the calendar year 1959, will range from 0.0% to 4.0% depending on the balance in the state fund. Certain employers whose accounts are overdrawn may be liable for a penalty contribution rate of 4.2%. ☆

Oregon gets $14 million Federal unemployment aid

ON ACCOUNT of the low level of the Oregon Unemployment Compensation Fund, reduced employer contribution rates effective April 1, 1958, were to have been scrapped and all Oregon employers were faced with the possibility of paying unemployment contributions computed at 2.7% of the taxable payrolls.

Governor Robert D. Holmes in an anti-recession move requested, and was

granted, a $14 million loan made possible under recent amendments to the Social Security Act. The $14 million, which must be repaid in the next four years, is sufficient when added to the almost depleted Oregon Unemployment Compensation Fund to increase the balance in the fund to a level which will prevent the imposition of the automatic contribution rate increase to 2.7% and will allow employers to continue to pay at reduced contribution rates. ☆

New York unemployment benefits extended

After two regular legislative sessions, one special session, two public hearings and three vetoes, Governor Harriman signed an Omnibus Bill amending the New York State Unemployment Insurance Law.

Based on an average weekly wage of $90, a New York State claimant is now eligible for a $45 weekly benefit amount. This maximum weekly benefit amount was raised from $36 and was made retroactive to July 1, 1957. Claimants who have been paid at the $36 maximum weekly benefit amount which was previously in effect will receive additional benefits provided revised benefit determinations indicate average weekly wages of $73 or more.

Where an individual heretofore was required to have at least 20 weeks of work during his base period to be eligible for benefits, he now needs only 15 weeks of work provided he has at least 40 weeks of work in the two-year period preceding the filing of a claim for benefits.

In connection with the disqualification or ineligibility for voluntary quit, misconduct, refusal of suitable work and for labor disputes, such disqualification or ineligibility will not be lifted if the claimant becomes re-employed after filing his claim for benefits. Prior to this change, a disqualified claimant who secured re-employment of only a one- or two-week duration from which he was laid off could draw unemployment benefits in spite of the disqualification which was previously imposed. Also the voluntary quit disqualification now begins at the time of the voluntary quitting of the employment, whereas prior to the change in the law the disqualification began after filing a claim for benefits.

A new experience rating schedule will go into effect beginning with the calendar year 1959. The new schedule increases from 2.7% to 2.9% the maximum contribution rate which can be assigned to a positive balance employer. Negative balance employers will be assigned a 3.0% contribtion rate for the first year of running in the red, and a 3.2% rate when running in the red two or more consecutive years.

Other changes which are likely to affect contribution rates assigned to employers have to do with the diversion of funds from employer's accounts when the amount in the general account falls below 1.4% of state-wide payrolls. The diversions will range from 0.1% to 0.5% of taxable payrolls. Also, employers will be charged a subsidiary tax ranging from 0.1% to 1.0% of taxable payrolls when the level in the general account falls below $100 million.

Although a change was made in connection with the filing of $10 and $25 fees which an employer must pay when taking an appeal from an initial determination or from a referee's decision, New York still remains the only state requiring such appeal fees. The amended law provides, however, that a single appeal fee may be paid where a common issue is involved. Heretofore, the appeal fee had to be paid for each and every claimant whose claim was being protested.

In regard to the receipt of vacation payments and the simultaneous receipt of unemployment insurance benefits, the law was amended to provide that, if a claimant is "substantially fully employed" by his employer in the last week before and the last week after a vacation period, to the extent the claimant receives vacation pay, he will be ineligible to receive unemployment insurance benefits. In order to render a claimant ineligible for benefits, the vacation payments must be made directly by the employer and not from a fund such as a union fund. ☆

Change in Missouri reporting requirements

The Missouri Department of Employment Security recently issued a bulletin to employers stating that Missouri employers will be required, when filing the quarterly wage reports, to insert the number of weeks for which each worker listed on the report was paid wages of $15 or more. Workers employed and paid at least $15 in wages for each week of the calendar quarter will be reported for the maximum 13 weeks. For workers who were not paid wages for every week of the calendar quarter, "week" means a payroll week; for workers who were paid wages on other than a weekly basis, "week" means a calendar week.

This new requirement results from a recent change in the Missouri law whereby, effective October 1, 1959, the definition of an "insured worker" will be a worker who has been paid wages of at least $15 for each of the last 17 weeks of his base period. ☆

New decisions

No penalty on corporate officer for failure to pay withheld taxes. The Government asserted the 100% penalty against plaintiff as a responsible corporate officer who wilfully failed to pay over taxes withheld by the corporation from its payroll. Plaintiff was a vice-president and attorney for the corporation and had custody of the books and records. Accordingly, he was an officer responsible for the taxes. However, the evidence showed that a CPA handled all of the accounting, and that taxpayer did not become aware of the depository method of handling withheld payroll taxes until after the corporation had become insolvent. From these facts the court concludes the element of wilfullness was not present and refunds the penalty to the plaintiff. *Clark,* DC Wash., 2/21/58.

Withholding tax required on ballplayer's bonus involving services. A bonus paid by a baseball club to a professional player solely for signing his first contract, without any requirement of subsequent service, is not wages subject to withholding. However, a bonus which requires the player to remain with the club for a certain period of time is subject to withholding. In either case, the payment is taxable to the player as ordinary income in the year received. *Rev. Rul.* 58-145.

Criminal penalties for employers who fail to pay over withholding. The Commissioner has called attention to P.L. 85-321 which makes it a crime to retain withheld taxes after two days' notice. While the law applies to almost all taxes, it is expected that the principal application will be to the failure of employers to pay over withholding taxes on wages. The Commissioner said that the law will be firmly administered. IR-214, 2/12/58.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

Local taxes on United States contractors upheld

On March 3 the United States Supreme Court handed down opinions in several cases which involve the taxation of property owned by the United States but in the possession of, or used by, private contractors. The validity of the tax was sustained in each instance. The rationale of these cases, applied generally, has already had important repercussions in other state and local tax fields, particularly in those instances where the test of taxability involves the precise terminology rather than the substantial and practical effect of a state or local tax law. The following comments are adopted from the bulletin of the Federation of Tax Administrators.

Borg-Warner v. Detroit

Michigan's Public Act 189 of 1953 provides that, when any real property which for any reason is exempt from taxation is leased, loaned or otherwise made available to and used by a private individual or corporation in connection with a business conducted for profit (with certain exceptions relating to use by the general public), it shall be subject to taxation in the same amount and to the same extent as though the lessee or user were the owner of such property. Taxes on leased property under the act are assessed to lessees or users and collected in the same manner as taxes assessed to owners of real property, except that such taxes do not become a lien against the property.

The United States owned an industrial plant in Michigan and leased a portion of it to the Borg-Warner Corporation for use in the corporation's private manufacturing business. The City of Detroit assessed a tax against Borg-Warner under Public Act 189, based on the value of the property leased and computed at the rate used for real property taxes. The tax was upheld by the lower court and affirmed by the Supreme Court of Michigan on the ground that the tax was not discriminatory, nor levied on the property of the United States, but was laid on the lessee's privilege of using the property in a private business conducted for profit.

On March 3, with two Justices dissenting, the United States Supreme Court also upheld the tax. The Court construed the statute as one imposing a tax on the private lessee. It rejected the argument of the Government that, since the tax was measured by the value of the property, it should be regarded merely as a contrivance to lay a tax on the property of the United States. Adverting to the precedent of the use tax cases, the Court distinguished a tax for the beneficial use of property from a tax on the property itself, even though measured by the value of the property.

The Court distinguished *United States v. Allegheny County*, 322 U.S. 174, by saying that the case involved no more than the old and widely used ad valorem general property tax, a tax imposed on the property itself and not on the privilege of using or possessing it. Justices Whittaker and Burton dissented on the ground that, since the tax is measured by the full value of the property owned by the United States, the tax is actually laid with respect to the ownership interest of the United States and is, therefore, invalid. The dissent conceded that the lessee's interest could be taxed, but pointed out that the value of a short-term leasehold interest is something different from the full value of the fee.

Continental Motors

There are two factual differences between the case of *Continental Motors Corporation v. Township of Muskegon* and the *City of Detroit* case. First, Continental Motors Corporation used the property under a permit, rather than a formal lease and, second, it used the property in the performance of its contracts with the United States.

The validity of the tax was upheld by the same division of the Justices as in the *Detroit* case. The majority stated that the factual differences did not compel a different result. The same Justices dissented and thought that the facts in this case strengthened the position taken in the *City of Detroit* case because here the contractor had no right to the use of the plant and no leasehold or other property interest in the plant.

City of Detroit v. Murray

Murray was a subcontractor under a prime contract between two other private companies and the United States for the production of airplane parts. From time to time Murray received partial payments for performing its obligations under the subcontract. Title to all parts, materials and work in process, acquired by Murray in performance of the subcontract, vested in the United States as partial payments were made, even though Murray retained possession.

The city and county assessed its personal property tax against Murray and included in the assessment the value of materials and work in process in the possession of Murray, but to which the United States held legal title by virtue of the title-vesting provisions of the contract. Murray sued in the United States district court for a refund. The district court decided in favor of Murray and the Sixth Circuit Court of Appeals affirmed the judgment. The United States Supreme Court reversed the judgment and upheld the tax, four Justices dissenting. Conceding that title to the property was vested in the United States and that the tax was called a personal property tax in the Michigan statutes, the majority said it was necessary to look through the label to the substance and held that, as applied, these taxes imposed a levy "on a private party possessing Government property which it was using or processing in the course of its own business."

The Court went on to say:

"In their practical operation and effect the taxes in question are identical to those which we upheld in [*Borg-Warner* and *Continental*] on persons using exempt real property. We see no essential difference so far as constitutional tax immunity is concerned between taxing a person for using property he possesses and taxing him for possessing property he uses when in both

instances he uses the property for his own private ends."

To the objection that the Michigan personal property tax law does not expressly state that the person in possession is taxed "for the privilege of using or possessing" personal property, the majority said:

". . . to strike down a tax on the possessor because of such verbal omission would only prove a victory for empty formalisms. . . . In the circumstances of this case the state could obviate such grounds for invalidity by merely adding a few words to its statutes. Yet their operation and practical effect would remain precisely the same."

The dissent raised three questions: whether the title vesting provisions actually vested title in the United States; whether the statute imposes a general ad valorem tax on the materials; and whether, if the materials were in fact the property of the Government and the tax was an ad valorem tax, such a tax could be constitutionally imposed. They answered the first two questions "yes," the third "no." ☆

New state & local decisions

Sales tax penalties upheld despite no-tax ruling. Taxpayer sold tile and accessories to tile contractors in wholesale quantities for use by the purchasing contractors in performing installation contracts made directly with real estate owners or with general building contractors. The taxpayer contended that it had twice made application for a sales tax registration certificate, but had been refused on the ground that it was not subject to the sales tax law. It said the state was, therefore, estopped from collecting the tax. The court held that the sales involved were taxable retail sales since the tile was not resold by the contractors, but used by them in fulfilling their contracts. As to the question of estoppel, the court said that the state could not be barred from collecting the tax in spite of advice given by agents of the tax department. On this latter basis the court also upheld the imposition of penalties on the taxpayer. *Claiborne Sales*, Sp. Ct., La., 11/12/57.

Detroit can sue ex-resident in Illinois. The City of Detroit sued in Illinois courts to recover personal property taxes for 1954 and 1955 from a taxpayer now residing in Illinois. The taxpayer contended that neither considerations of full faith and credit nor comity required or authorized the City to bring action in Illinois courts and that the generally established rule that revenue laws of one state will not be enforced in the courts of another precluded the action. The court traced the history of the "time-worn and oft-repeated" doctrine precluding extrastate tax enforcement, but concluded that this has been superseded by a modern view that states will enforce the revenue laws of a sister state. (The legal aspects of extrastate tax enforcement were discussed in an FTA memorandum, RM-293, prepared in July 1950. The memorandum commented on the difficulties in obtaining uniform adoption of reciprocity statutes and observed that the common-law doctrine might well be established as the majority rule.) *City of Detroit*, Sp. Ct. *Ill.*, 11/20/57.

U. S. liquor taxes held part of gross receipts of retailer. For purposes of the Illinois Retailers' Occupation Tax, persons engaged in the occupation of selling packaged liquor goods at retail may not deduct from gross receipts the value of Federal and state liquor stamps attached to the bottles they sell. The court held that the liquor retailers could not be construed to be either purveyors of revenue stamps or collectors of prior taxes through the trade custom of fixing prices to include the tax burden. It ruled that the taxpayers were engaged only in selling liquor and the taxes in question were paid by the distillers before the product ever reached the retailer. *Fischman & Sons, Inc.*, Sp. Ct. Ill., 11/20/57.

U. S. leased machines held exempt. Electric accounting machines owned by taxpayer were leased to the Air Force for use on land ceded by the State of Florida to the United States. When the land was ceded to the Federal Government in 1937, it was given exclusive jurisdiction except for the execution of criminal and civil process. The argument that the machines were subject to property taxation was based on the uniformity provision of the state constitution and provisions in the deed itself relating to execution of process. The taxing authorities took the position that organic law was part of the deed of cession and thus the instrument could not operate as an exemption of private personal property. The court found no indication in the provisions of the deed that the state intended to retain the right to tax property located in the ceded territory even if it could do so. It held the property tax invalid. *International Business Machines*, Sp. Ct. Fla., 11/27/57.

Basis can be lower than value upon entering state. In 1952, a husband and wife, Louisiana taxpayers, sold stock they had purchased in 1932, when they were non-residents. In determining the tax due from the sale, the state collector of revenue fixed the net gain on the basis of value of the stock on January 1, 1934, the date the Louisiana income-tax law became effective. The taxpayers contended that the gain should have been based on the value of the stock as of June, 1937, when they moved to Louisiana. Taxing on the basis of the earlier date, they argued, gave an extra-territorial effect to the Louisiana tax. The court upholds the procedure followed by the collector of revenue. It took the position that realized income, and not the year-to-year increase in the value of the stock, was taxable, since it was not until the taxpayer obtained his profit that he became subject to tax. *Olvey*, Sp. Ct., La., 11/12/57.

Virginia express company tax litigated again. Under Virginia law, foreign corporations are prohibited from engaging in a general express business. As a result, a national express company established a subsidiary in the state to handle intrastate business and restricted its own activities there to interstate business. Originally, Virginia sought to subject the foreign corporation to an apportioned gross receipts tax. Although termed a privilege tax, the Virginia court of appeals upheld the levy as a property tax measured by gross income and laid on the intangible value of goodwill or going-concern value. In 1954, however, the United States Supreme Court held the tax to be in fact a privilege tax and, therefore, invalid when imposed on a corporation engaged exclusively in interstate commerce. In 1956, Virginia amended its public service corporation tax law. The amended law differed from the one in effect

previously in that the latter had imposed the gross receipts tax in addition to state taxes on intangibles and local property taxes. The express company again contended it was not taxable since it was engaged exclusively in interstate commerce. The state corporation commission estimated taxes due by computing, according to mileage, the proportion of the company's receipts from express transported on railroads and airlines in Virginia to total receipts from the express it transported over the entire lines of these carriers. The court upholds the validity of the amended tax. It says that the franchise tax is a property tax and, therefore, its imposition here is not barred by the Federal Constitution. In response to the company's contention that the amount of the franchise tax was out of proportion to its property in the state, the court cited the large intangible value resulting from the company's ownership of the express privileges obtained through exclusive contract with many transportation companies. This, it said, resulted in earnings which were attributable partly to Virginia. Since the company had not reported its gross receipts or submitted any evidence on the relationship between its property and its revenues in other states, the court accepted the finding of value of the Commission as correct. It held that the burden was on the company to disprove the accuracy of the assessment and that, by centering its attack on the unconstitutionality of the statute, it had not. *Railway Express Agency*, Sp. Ct. Apls., Va., 12/2/57.

No North Carolina carry-forward for merged corporation. Of three North Carolina corporations which merged in 1954, one had sustained an economic loss in 1953 which had been only partially offset by subsequent income earned prior to the merger. North Carolina's income tax law permits corporations to carry forward certain kinds of losses as deductions against income accruing in either of two succeeding years. On the basis of this law, the successor corporations sought to deduct the balance of the loss remaining when the firms merged. In denying the deduction, the court pointed out that most of the cases involving the right of a successor corporation to claim a loss sustained by another corporation have arisen under Federal law and that such claims have been repeatedly denied on the ground that the claimant was not the taxpayer within the meaning of the statute. The court held that the legislature had denied consolidated corporations the right to carry over a loss and that, therefore, it would not have allowed this right to the surviving corporation of a merger. *Goodwill Distributors (Northern), Inc.*, Sp. Ct., N. C., 11/20/57.

No sales tax on sale of repossessed vehicle. A dealer reacquired title to vehicle from finance company to which the dealer had previously assigned conditional sales contract under which original sale had been made. On rehearing, the court reversed its earlier ruling (January 17, 1957) and held the resale of the car by the dealer not subject to sales tax because the car had not been "bought" by the dealer for purpose of resale within meaning of sales tax statute. *Hayes Chevrolet Company*, Sp. Ct. Ala., 11/24/57.

Property abroad assigned to state. In the numerator of the property factor of the franchise tax apportionment formula, taxpayer had included raw materials purchased for delivery to and use in its San Francisco plant, but which then was on the high seas or in foreign ports. Later, taxpayer contended that property should not have been assigned to California since it had acquired no situs in that state. The Board held that the only express requirement of the statute was that the method used be fairly calculated to apportion the business among the places where the business was conducted. The taxpayer was not conducting business in foreign ports or on the seas, the Board said, since it acted there only through independent contractors. The procedure used did not conflict with the statute and did not produce a manifestly unreasonable result. *Ames Harris Neville Co.*, Bd. Equal. Cal., 11/21/57.

Use tax due upon incorporation of business. Taxpayer incorporated his moving and storage business and transferred 17 motor vehicles to the new corporation. When he sought to have the registrations changed, transfer was refused until the corporation paid a use tax of $1,066.56. The corporation claimed it was not subject to use taxes because (1) no sale, as distinguished from a gift, had occurred and (2) the corporation consisted of the taxpayer, his wife and children and, under the Connecticut law, casual sales to the seller's spouse or child are not subject to the use tax. In upholding the imposition of the tax, the court found nothing in the stipulation of facts to negate the implied contract of purchase. With respect to the exemption for casual sales to the seller's immediate family, the court held this could not apply in this case since to disregard the corporate entity would be contrary to the exemption provision. *Amodio*, Sp. Ct. Errors, Conn., Oct. term 1957.

Assessments on audits down in Maine

DURING THE YEAR ending June 30, 1956, 1,189 audits of taxpayers' accounts were conducted by the filing staff of the sales and use tax division of the Maine Bureau of Taxation, resulting in assessment of $311,696 in tax, interest and penalties. Comparable figures for the year ending June 30, 1955 were 1,318 audits, $343,826 assessed. The fact that assessments upon audits this past year were less than for any of the three previous years was held to be an indication of more careful reporting on the part of taxpayers, according to the 1956 report of the bureau of taxation. ☆

New Mexico deletes exemption for sales to U. S.

IN 1957, the New Mexico legislature amended its emergency school tax act, which imposes a gross receipts tax on the privilege of doing business in the state, to remove an exemption previously allowed for sales to the United States, its agencies and instrumentalities. The New Mexico attorney general, in an opinion given on September 27, has ruled that under the act, receipts from sales to, or for services performed under contract for the federal government, in connection with the conduct of a business in the state, are not exempt from the levy. The opinion states that the 1957 amendment was enacted after the legislature was advised of a series of United States Supreme Court decisions upholding the imposition of privilege taxes based on gross receipts which included sales to the federal government. The attorney general observed that the New Mexico tax is not subject to the "immunity" doctrine since it contains no requirement that the licensee pass the tax on to the purchaser. ☆

MANAGEMENT OF THE

Professional tax practice

AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

The CPA's tax practice: setting fees, keeping records, billing, costs

by **BERNARD B. ISAACSON**

Most CPAs keep the same kind of client records, time sheets and cost accounts for their tax work as they do for auditing. This works out well if a few modifications are used; but when it comes to fees and billing, the CPA won't be getting a fair return unless he adopts a radically different policy. Mr. Isaacson, Wilmington, Delaware, CPA, tells us about the records his firm uses and discusses the criteria the tax man should use in setting fees. Lawyers, especially those who are unsystematic about records and billing, will find interest in this article and derive profit from it.

We start our routine at the time we are engaged by a client. We complete a form called the New Client Data Sheet. On this data sheet we show the name, address, the city and state, and the work to be done for the client; whether the work is to be done monthly, quarterly, semiannually or annually; whether it is accounting, financial statement, audit report, payroll reports, close books, systems, or anything special that has to be done for the client. We show what tax returns have to be filed; whether they are Federal or state returns.

From this form we start our clerical routine. The form goes to a girl in the office who issues the client file number. That file number follows that client forever.

We have an addressograph plate for each client. We send out our own newsletter. This we write ourselves, giving various filing due-dates and other information, such as what the Internal Revenue Service is examining at the present time. We also tell of the new depreciation methods that have been approved, and regulations that we think are interesting to the client. We find that our newsletter keeps those clients who see us once a year, at the time we prepare their tax return, coming back to us each month. Not physically, but at least mentally they know that we are thinking of them 12 times a year.

We have a tax file card which helps us in our scheduling of tax returns. The telephone index, the client's work schedule and an engagement sheet, if necessary at that time, are also prepared. This indicates whether we start working on the client immediately or whether we schedule it for a later date. We then list it on our partners' reports so that all partners know what clients we have. That may seem strange, but sometimes you get a new client and forget to tell your partner and then someone walks in and wants to know something about a client and he says, "Who? What?" It is quite embarrassing. Every partner should know what is going on in the firm.

The schedule card that we have is ruled with 12 vertical columns showing the 12 months and horizontally showing the type of work to be done. In this information section we have the name, the address, and the type of business. This card also shows the person to contact in the client's office if necessary.

Engagement sheet

Our bookkeeper goes through these cards, which are in aphabetical order, every month and looks under these various columns to see which are checked. Check marks indicate what work has to be done for the client, and our bookkeeper then makes up a client engagement sheet. We do not allow any work to be done in our office unless it has been scheduled. If we do not have a regular engagement we make up a supplemental engagement sheet, but no one can work on any job unless an engagement sheet has been prepared. In that way we have control as to what work is being done in the office.

The engagement sheet indicates what is to be done. We have a separate color for each type of work. We have a journal entry engagement sheet which is gray. An engagement sheet for accounting and auditing work is on yellow paper. The tax return engagement sheet is on pink paper. The payroll engagement sheet is on green, and the supplemental or special engagement sheet is on buff paper. What does an engagement sheet have on it? The tax return engagement sheet will give you a pretty good idea of what the others contain. This is made up by our secretary once a month. She types the client's name and address, the client file number and the engagement code. For example, 704 would indicate that the fiscal year ended in 1957, that it was a fourth month, April audit, etc. The type of return, whether it is a Federal return, a state return, etc., is also shown, with the name of the state indicated. Then the need for an estimated return is indicated. Also shown is the type, individual, partnership, corporation or other, and the date promised. We have to indicate on the form the number of copies of returns to be prepared. We multilith many of our reports because it is easier to multilith four or five copies or more than to have them typed with carbon. The number of W-2's that have to be attached to the tax return is also indicated, as is the date the return is due. We put that in big red pencil so that the man who is working on the job, or the typist, will keep in mind the date the return has to be filed.

We also show to whom the bill is to be sent. Many times individuals have arrangements with their companies or someone else to make the payment. Many times children are not billed directly but rather the parents are billed.

We also state the latest year of the Internal Revenue examination. You often have to follow up on a lot of adjustments that affect other years, so we indicate that on the sheet and have a man check the files for the revenue agent's examination. We even have pro-

vision for revised copies on this engagement sheet. Finally, we show the name and the date that the person does the work. Then we have a line to show whether the self-employment tax return must be prepared. It is quite important to look for that. Then we list the state tax returns and the estimate if needed. Many of our clients do not want their estimates prepared until about April 10. Some of the executives of the larger companies do not know until about April 10 what their salaries will be or what their estimated bonuses will be for the coming year. The rest of the returns may be done earlier, but the estimate is not done until the last minute. We then show if extensions were granted and the date.

After a return is prepared, our tax partner reviews it. After that the scroll copies are checked by juniors who do all the actual mathematical totaling, checking and computation. Then we have the returns and the schedules typed or run off on the multilith or thermofax. The copies are then checked again. The returns are assembled and all copies are dated and the client's copies are stamped before the final review which usually is done by another partner who looks it over just for appearance. It is all put together and the schedules are attached. We date the engagement sheet and show whether the return has been mailed, delivered or picked up. This engagement sheet goes to the tax partner, who keeps our tax file and he enters it on a tax file card. There may be client's material to be returned or special mailing instructions to be observed; this is so indicated. We also indicate prior years' operating loss carryover, carryback, capital loss, etc. That covers the engagement sheet, and basically they all run the same route through the office.

For payroll tax reports which go out every three months we have letters of transmittal. They are multilithed, giving full instructions as to what to do with each return. Each particular form, whether it is Federal or state, has its own instruction sheet. There are blank spaces where the girls write in in red pencil what has to be done and the amount to be paid. We find that helps considerably and the clients like that a great deal because it makes it easier for them to know the amounts for their checks. We use similar letters for the corporation return and for the various income tax returns. The form also indicates refunds or whether the estimate of their refund has been applied against next year's estimate. All that is on these forms. I think if you will follow this procedure, you will save yourself a lot of typing time.

When we send the returns, we also send to each client a return postal card which has been addressed to our office, and on which is shown the date the client mailed his returns.

Other forms

We have a weekly time report which indicates just the client's name, the service rendered to the client, and the hours. It is given to the bookkeeper every Monday morning. All men turn their reports in and they are posted to a time record on which we show the auditor's name, the type of work based upon whether it is a special job or the regular monthly audit, the hours and then his rate. It may be five, six, seven, eight, ten, 15 dollars an hour, whatever the rate for that particular job may be. The expenses that go along with it are posted, and then the total of the work in process is accumulated. On the same card we have the accounts receivable record which indicates the date of the invoice, the invoice number, and the amount of the invoice. For example, say we billed $100 though our billable time came to $110; we put in an adjusted total, a red figure of $10; we lost $10 of billable time on that job. On the other hand, if we do $90 worth of billable time we should show a black figure which brings it up to the hundred-dollar bill, and when it is paid we show the credit. This, therefore, serves as both our work-in-process control and our accounts receivable control. It is the only record we have besides the actual copy of the invoice and our general ledger control. We don't record the value of work in process on our formal books and statements.

In order not to lose money in our own office we have a form called "out-of-pocket charges," for postage that a man may spend when he has a large number of confirmations, or any particular expense he may have for the client. It goes to our bookkeeper for posting to the time record. We have the same thing for a telephone charge. A little form indicates the client and whom it is to be charged to. You would be surprised how that adds up in the course of a month. Sometimes we have as much as $100 or $150 worth of telephone charges to be charged to clients.

I was taught that the formula for fees should be 40-20-40; 40% for the cost of your staff men, 20% for overhead, and 40% for partners. Now if anyone tells me that he can maintain this formula, I would like to talk to him. I find it is impossible to get that 40-20-40 formula, but we all have hopes. The fees should be reasonable, yet fair. Reasonable for the client, and fair to you. And there is the old story, the staff man is always underpaid, in his estimation, and the clients are always being overbilled, in their estimation. You are in between. If possible, send out your bill and stick to it. I wish we could do it but we cannot.

I think CPAs all believe as I do that tax work should carry a higher rate. We bill all our men at $10 an hour for tax return preparation. We do not always get it, but at least when a client comes in and complains about a bill you can show him your time record and say, "Look, the man put in seven hours of work and we billed you only $50." You say, "I lost $20." At least he does not feel so badly and he may not try to get the fee down. I think we should come to the realization that we should charge more for tax work, not because it may be more difficult, but because we have to put in more time, during the course of a year, reading tax material, keeping up with changes and tax cases. The client has to pay for it along with all the energy and knowledge that goes into that work when you prepare the tax return once a year. You have to maintain an office for the client who comes in once a year and pays $50 for a tax return, or $25 or $100 and that is one reason why you should get more. We use our time records only as a basis, a guide. We try to evaluate the work as it comes through.

How about the charges on a tax examination? I think that an attorney friend of mine gave me some very good advice at one time. He said, "The best time to get a fee in a tax examination is when the Internal Revenue is breathing down a client's neck." Get your fee in advance. I think that is the wisest thing to do. I'll admit that in many cases, particularly when clients have been with you for a long time, I do not see how you can do it.

A CPA wrote me that he has a lot of trouble with clients who expect him to handle a tax examination for the one single fee that he received for preparing the tax return. He suggests that everyone add a little note to the invoice for

the tax return: "Your fee covers preparation of your income tax return. It does not cover assistance rendered during any examination of your return by the Internal Revenue Service. We will be happy to assist you should this occasion arise and will make an additional charge based on the additional services rendered."

Here is one piece of advice to the younger practitioners which I wish someone had given me. Do not set fixed fees when you take on an engagement. I have been in practice 12 years and there are some clients who will not pay us more now than they paid us 12 years ago. It is the toughest thing in the world to get someone to pay from $50 a month to $60 a month, though he knows as well as you that your cost has gone up. Try a budget basis. Tell the client you will bill $50 a month, then at the end of the year you will know how much time you have put in and you will bill for the additional time rendered. I think if you can sell your clients on this you will be doing yourself and them a service. At least you know that you will get paid for the work you do and you will not hesitate to give him that little extra bit of service. At times we, too, will say of a pinch-penny client who needs a little extra work, "Oh, the Devil with him. He's too tight, we're not going to do it." I think this hurts you and your client. Try not to fix your fees on a set basis.

Each locality has its own problems. I speak of $10 an hour. Some come from localities in which, if you were to tell your clients you are charging $10 an hour, they would tar and feather you and chase you out of town. Yet on the other hand, when I talk about $10 an hour, people up in New York think I am crazy. They charge a lot more, as they do in some other metropolitan areas, but you have to keep your fees in line with the location of your office. These figures are only a guide.

Staff pay

I am going to try to cover staff pay. As I said, the staff man is always paid too little, in his own estimation. You cannot blame him. Life is a struggle between paying and being paid. Pay what you can reasonably and get the best man you can for the salary, and be selective. I think a good staff man is worth his weight in gold, if for no other reason than to relieve you of a lot of details so that you can go after new services for clients. If you have at least two or three men, and you get a staff man to a certain level and you know that you cannot pay that man any more (you have to have a senior or a semi-senior or a junior, and just as in the army, the table of organization does not permit you to have any more), tell the man frankly whether or not there is a possibility of taking him as a partner. If there is and there is the possibility of growth, take him in. But if there is no possible way this man can come in as a partner, be frank about it and get him a job with a client as a comptroller or let him do as he sees fit, and then replace him with a junior and let the junior move up to semi-senior to senior. You have to keep a wheel going all the time. Many people complain that their men leave to go into practice for themselves, but can you blame them? That is what most of us did. We left someone else and went into practice for ourselves, but it hurts when you are on the other side.

I have had a philosophy from the day I started, and I hope you will realize it is worth a lot of thought: Have one man more on your staff than you need. Now everybody immediately thinks, "$3,000 a year, I can't spare it." I will tell you what you will find. You will not want to see that man sitting around doing nothing. You will think of additional things to do for your client, to increase your fees. You will dream up things for the client which he should have had in the first place. They will pay you more fees for that. Then you will begin to realize that the man is not sitting around idly and that you have a little more time to discuss things with your client, and that is what he wants. You can hire pencil pushers, but business management is what they really want you for and is what you should give them. Having that extra man on your staff will give you the time to do it. It will give you the ability to sit and discuss matters of importance with your client. You will be surprised that the $3,000 will begin to earn $5,000-$6,000 for you. Try to have someone on your staff handle details so that you will have the time and energy to render more service to your client. When you give more service, you get more fees. Of course, this too is dependent upon the area you are in. If you are the only CPA in the area and you have all you can do, of course it does not apply to you. Others should think about it. You may have a girl in the office who can do detail work so that you can have an extra half hour a day or an hour a day or half a day a week to do business management for clients. I think you will find it pays off.

We have engaged senior students during their vacations. Many times it is pretty costly to have a man to whom you pay a good salary sit around in the office during the summertime and not work all of the time, but it helps during vacation time when other men are off. It helps when you have a special job that you can do during the summertime, but most important, that man comes back to you when he graduates and becomes a good staff man. Having been fairly well trained you can put him into a job almost immediately because he has had two and a half or three months training with you during the past year. That happened to us this past year. A year ago we hired a boy who worked with us during the summertime. This year he came to work for us full-time. It is a gamble you take but sometimes it pays off, and maybe during the summertime you may take some time off yourself because you have another man around the office and you can do a little fishing or golfing and relax to get back some of the energy you expended during the tax period. It sort of rejuvenates you and also gives you an opportunity to look into this additional service for clients, business management. Look over your own record and see what you can do. Maybe you can give the client a better type of statement. Think about it. I think you will find it worth while. ☆

Today's salary is worth about 40% of 1939

UNDER PRESENT-DAY TAXES and inflation an income of $23,568 is needed to provide take-home pay with the equivalent in purchasing power of $10,000 in 1939. Then income and social security taxes on $10,000 amounted to $269 and the net annual income was $9,731. Today, in order to end up with take-home pay equivalent in purchasing power to $9,731 in 1939 dollars, it is necessary to earn enough to net $18,791 after $4,777 in taxes has been paid.

The spread between salaries today and in 1939 widens as the amounts increase. For example, it takes $6,457 today to equal $3,000 then, but to match the purchasing power of $100,000, he would have to receive $357,009. ☆

TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

Collapsible partnership rules too complex; simplification proposed

MOST TAX MEN ARE STRONGLY CONVINCED that the Code ought to contain a barrier to a partner's converting ordinary income into some form of capital gain; Section 751 of the Code, however, has probably gone too far in its attempt to cover all possibilities. As a result, it has become almost too complex to be understood. It is not surprising, therefore, that one of the most important suggestions for revising Subchapter K submitted by the Advisory Group of Practitioners to the Subcommittee on Internal Revenue Taxation (Mills Committee) was that this section be considerably simplified.

Their notion of how to get out of the present difficulty would be to:

1. Have Section 751 apply to sales and exchanges of partnership interests only, not to distributions to a partner. Abuses of distributions would be prevented by requiring the partner to treat the distributed assets as non-capital if that was their character in the hands of the partnership.

2. Limit the application of Section 751 to gains of over $1,000.

3. Apply the special rules of Section 751, not to specially defined appreciated inventory and unrealized receivables, but to all non-capital assets. The Committee proposes a new formula to determine whether there has been substantial appreciation.

The trouble with the present Section 751 arises, not from its objectives, but from the methods used to achieve those objectives, particularly the attempt to cover sales (and exchanges) of partnership interests as well as distribution of assets to a partner.

As the practitioner's group put it, "Section 751 of present law relates both to certain sales and exchanges of partnership interests and also to distributions by a partnership where either the distributee, or the remaining partners, in effect are exchanging their interests in certain types of partnership property. The types of property with which this provision is concerned are 'unrealized receivables' and 'inventory items which have substantially appreciated in value.' The existing statute presents detailed definitions of unrealized receivables and inventory items. In addition, two tests are applied in determining when there is substantial appreciation in the inventory items. For the gain attributable to the inventory items to be treated as ordinary income their fair market value must exceed 120% of their adjusted basis and also the fair market value of these assets must represent more than 10% of the fair market value of all partnership property other than money.

"Your advisory group accepts the basic objective of the present Section 751; namely, that it should not be possible to convert any substantial amount of what would otherwise be ordinary income into capital gains by selling partnership interests or by distributing partnership property. Nevertheless, it believes that a substantial simplification of this section is essential. The group believes that the present version of this provision is too complex to expect the average partner to know how to apply it and that it must be simplified even though in so doing some of the theoretically correct results of the present provision may be lost.

"The most serious complications in applying this provision arise in the case of distributions. In such cases not only must there be a determination as to whether the assets involved are, or are not, Section 751 assets but also there must be a determination of whether the distributee is receiving more or less than his pro rata share of these 751 assets. Where these conditions are met it is also necessary to determine the assets which were exchanged for the 751 assets. Thus, it is necessary to compute not only the amount of ordinary income with respect to the 751 assets, but also any capital gain realized with respect to the assets exchanged for these Section 751 assets. Because of these complexities your advisory group is recommending that Section 751 be made inapplicable in the case of distributions. At the same time, however, it is proposing changes elsewhere in the partnership provisions to prevent the use of distributions as a means of converting ordinary income into capital gains. This is accomplished by providing that where Section 751 assets are distributed by a partnership they are always to retain the same character in the hands of the partner as they would have had in the hands of the partnership. As further assurance against the conversion of ordinary income into capital gains it is proposed that where a partnership makes a distribution, even though having elected to make adjustments to the basis of partnership property, it is not to be permitted to make any adjustments to the basis of Section 751 assets of the partnership."

Proposed treatment of distributions

These tax men recognize that the treatment they propose will permit partners, by making non-pro rata distributions, to shift income from one partner to another; however, the simplification achieved would be, it believes, worth it. Furthermore, it would be ordinary income that would be shiftable. Transmutation into capital gain would be foreclosed by the rules it proposes for determining the character of the distributed assets in the partner's hands.

"The existing statute," the Group points out, "provides for the application of the ordinary income treatment in Section 751 (a) in the case of non-pro rata distributions by a partnership, or in other words where in effect there has been a sale or exchange of an interest in Section 751 assets, either by the distributee partner or by the remaining partners. This provision is deleted entirely by your advisory group's proposal. It is recognized that the deletion of this provision makes it possible to shift ordinary income between partners. However, to some extent this already is possible under existing law as the result of the general treatment accorded contributed property under Section 704(c)(1) and

as a result of the rules set forth with respect to a retiring or deceased partner in Section 736. The deletion of this subsection is believed to be essential as a substantial simplification, despite this effect. However, modifications proposed in connection with this revision in the case of Section 735(a) [discussed in more detail below.—*Ed.*] and Section 755 are designed to prevent the partners from converting into capital gains this ordinary income which has been shifted. In the case of Section 735(a) it is provided that Section 751 assets will always retain their character in the hands of a distributee partner, while the present rule preserves the character of inventory items for a period of only 5 years after the date of distribution. Section 755 is revised to prevent the adding of any basis to Section 751 assets in the partnership where a distributee partner has relinquished an interest in Section 751 assets.

"Despite the deletion of subsection (b) of present Section 751, [application to distributions.—*Ed.*] it is intended that the parties, by agreement, still would be permitted to accomplish the results obtained by this subsection (b) of existing law. In other words, if the partners agree, a disproportionate distribution of cash by a partnership may be treated as first constituting a distribution of 751 assets, and then a sale of such assets to the partnership by the distributee for cash, with the result that ordinary income will be realized by the distributee partners and a step-up in basis will occur with respect to the 751 assets "purchased" by the partnership. For this result to obtain, however, the records of the partners and partnership must indicate that the partnership in form made an initial distribution of 751 assets and then that the distributee made a subsequent resale of these assets to the partnership."

Partner's basis for distributed assets

Turning to the character of the distributed assets in the hands of the partner, the Group discusses the changes it proposes. "In connection with the simplification of Section 751," it says, "the advisory group is proposing the elimination of Section 751(b). This subsection presently provides ordinary income tax treatment for a distributee partner to the extent that in a distribution he relinquishes his share of the partnership's unrealized receivables or substantially appreciated inventory items and receives other property in exchange for these assets. Alternatively, Section 751 (b) also provides ordinary income tax treatment for the remaining partners to the extent the distributee receives more than his share of the unrealized receivables and substantially appreciated inventory items in exchange for his share of other property of the partnership.

"Although the advisory group believes it is desirable to eliminate 751(b), it does not believe that partnerships or partners should be able to convert ordinary income into capital gains. Since the proposed revision of Section 751 would not treat as ordinary income to the remaining partners any disproportionate distribution of unrealized receivables or substantially appreciated inventory items, the group concluded that it would not be proper to allow the distributee to avoid ordinary income treatment on any subsequent sale of these assets. Therefore, it is recommending that Section 735 be changed so that any gain on such assets upon subsequent sale result in ordinary income to the distributee regardless of how long he has held these assets. Thus (as now is the rule for unrealized receivables) inventory items would result in ordinary income upon sale even if held for more than five years." [i.e., Present law provides the gain on sale of unrealized receivables is ordinary no matter when realized; it is ordinary on inventory only if sold within five years. The Group would have the gain on all noncapital assets distributed ordinary no matter when sold.—*Ed.*]

Exclude gains under $1,000

One of the Advisory Group's proposals that would narrow the application of Section 751 is its suggestion that would limit its use to those cases "where the gains attributable to Section 751 assets exceed $1,000. The application of the provision also would be narrowed by clearly applying the section only where there is an over-all gain on the sale or exchange of a partnership interest, that is, taking into account not only the portion of the proceeds from the sale or exchange attributable to Section 751 assets, but also the portion attributable to all other assets."

Broader definition of 751 assets

"Present law," the practitioners say, "provides a detailed definition of both unrealized receivables and inventory items and these definitions have included some types of items which appear questionable and may have excluded others which appear equally questionable. These definitions are dropped in the proposal. The test provided is basically a simple concept; viz, the character of the income in general is to be determined in accordance with the character it would have if the transferor partner were selling the property directly rather than selling or exchanging an interest in partnership property. The use of this concept not only makes it unnecessary to develop a special set of rules for determining what constitutes a Section 751 asset, but also makes applicable the capital gains rules with which taxpayers have already generally become familiar.

"The new subsection (c) includes in the term 'Section 751 assets' all property of the partnership which if sold or exchanged at a gain would be property which would result in ordinary income. In addition, in order to give the taxpayer the offsetting benefit of ordinary loss which would be realized on a sale by the partnership of property used in its trade or business, the term Section 751 assets includes property described in Section 1231(b) [old Section 117(j) of the 1939 Code.—*Ed.*] to the extent that a sale of all such property at fair market value would result in a net loss.

"The proposed subsection provides rules which are to be followed in determining when there is ordinary income or when a Section 1231 net loss occurs. For purposes of simplification the different treatment under other provisions of law accorded certain assets if held for less than 6 months is ignored. That is, for purposes of this provision, all property is treated as if it were held for 6 months or more (whether or not actually held for such a period). This avoids the complexities inherent in attempting to provide separate treatment for short-

Advisory Group of Practitioners

MEMBERSHIP of the Advisory Group of Practitioners reporting on Subchapter K consists of the following:

Arthur B. Willis, Chairman
Harry Janin, Vice Chairman
Mark H. Johnson
Paul Little
Donald McDonald
Herbert B. Story
Laurens Williams

term capital gains and long-term capital gains."

New "substantially appreciated" rule

The Group would substitute a single measure "for the dual test of present law in determining whether or not there has been 'substantial appreciation,' in such a manner as to preserve the essential features of the present statute. Present law," it says, "determines the existence of any substantial appreciation by examining whether there has been appreciation in the value of the inventory involved of more than 20% and, if this is true, whether the value of the inventory represents more than 10% of the total value of partnership assets other than money. This dual test under your advisory group's suggestion would be replaced by a single formula which takes both of these factors into account. Under the proposal, Section 751 would be applied with respect to an interest being sold or exchanged only . . . if the potential gain with respect to the assets being sold represents more than 15% of the selling price of the interest (reduced for any partnership liabilities relinquished as a result of the sale.)

"In revising the existing subsection (d)(1) the new subsection substitutes a single ratio for the dual ratio of present law in determining when "substantial appreciation" has occurred. Moreover, the new test is applicable to all Section 751 assets, not merely to inventory items. The recommendation for this single test is made primarily to permit the elimination of the difficult distinction between inventory items and unrealized receivables. The new test makes Section 751 inapplicable, unless in the sale or exchange the gain attributable to the Section 751 assets exceeds 15% of the amount realized in the sale or exchange of the interest. In determining the amount realized on the sale or exchange of the interest, however, a reduction is to be made for the portion of the liabilities of the partnership allocable to the partnership interest being sold or exchanged. This latter reduction is necessary to prevent partners from avoiding the 15% test by artificially increasing the total amount of partnership assets (and hence the proceeds received upon sale) through the use of borrowed funds."

By reducing the amount realized, for purposes of the 15-per cent substantial appreciation test, by a pro rata share of the partnership liabilities, an unintended benefit in the present provision is removed whereby real-estate developers, through the use of mortgaged property, may avoid ordinary income on substantially appreciated Section 751 assets. ☆

New partnership decisions this month

Children not permitted to deny validity of family partnership. Taxpayers sought to disavow the existence of a partnership with their parents in spite of the existence of a partnership agreement, by emphasizing the fact that neither of them rendered significant services to the business. The court finds that the partnership business was merely holding investments and consequently required no significant services; that each taxpayer filed income tax returns in the past reporting his distributable share of the partnership income; and that each had sworn under oath during an investigation of the father's affairs that he was a bona fide partner. It, therefore, holds taxpayers were bona fide partners during the years in controversy. *Ferguson,* TCM 1958-32.

Daughter a bona fide partner. On remand from the Fifth Circuit to consider on the merits all the issues presented, the Tax Court finds that taxpayer's daughter was a bona fide member of a partnership in 1947, even though she contributed no services. The partnership dealt in machinery and the daughter had done considerable office work for the business in prior years. She did contribute some capital and really intended to join in the business. Accordingly, the Commissioner's determination that taxpayer realized a gain upon a transfer of the partnership assets to a new corporation was erroneous since it improperly assumed taxpayer owned his daughter's interest and was entitled to the stock issued to her. *Gugenheim,* TCM 1958-41.

Partner's gross income includes his share of firm gross. Section 251 of the 1939 Code permits U. S. citizens to exclude income sources within U. S. possessions if certain conditions are met. One of these conditions is that 80% of the gross income for three years prior to the taxable year must have been derived within a U. S. possession. In determining whether taxpayer, a member of a partnership, met this 80% test, the Tax Court held that he must include in his personal gross income his distributive share of the partnership's "gross" rather than the "net" income. This court affirms. Although the language of the Code literally required the partner to include his share of the partnership net, the cases have considered that each partner owns a share interest in the partnership gross because the partnership is not a tax-paying entity. Only in the case of the 25% income omission for statute of limitations is the partnership net regarded as the partner's gross. *Palda,* CA-8, 3/6/58.

Partner can't deduct taxes paid on behalf of co-partners. One partner who paid all the New York State income taxes of his partners, together with the New York unincorporated business tax of the several partnerships in which he was a member, is denied a deduction for the payments as ordinary or necessary business expenses, or as partnership losses, except to the extent that the unincorporated tax is allocable to his interest in each partnership. However, the legal fees paid for making the tax settlement with the state are held to be fully deductible by the partner since the benefits secured in the settlement were primarily for his advantage and only incidentally for the advantage of the other obligors. There was evidence that taxpayer intended to make a gift to other partners in relinquishing his right of contribution for the taxes from them. *Farnsworth,* 29 TC No. 119.

Partner's wife became limited partner at his death. Taxpayer's husband died in 1946 and, pursuant to agreement, taxpayer continued to receive payments from his partnership. The Tax Court held that taxpayer became a limited partner in the partnership at her husband's death and that she must therefore include in her income her distributive share of partnership profits for that year. That court also held that the partnership properly credited taxpayer with the full amount of her distributive share on the partnership return, even though she was not actually paid that much. This court affirms without opinion. *Laube,* CA-3, 3/25/58.

THE TAXATION OF INDIVIDUALS

Personal tax problems

Inequities in 36-month compensation: bar group proposes relief measures

TESTIMONY BEFORE the House Ways and Means Committee brought out many of the small quirks in the Code that work inequitable results for many taxpayers. The Taxation Section of the American Bar Association presented a half dozen proposals for change (all approved by the ABA House of Delegates) none of which is of major significance, but which would remedy a technicality which works harshly on taxpayers.

The relief from income bunching offered by the few averaging provisions now in the Code is extremely limited; the Section proposed one change which would have the effect of permitting the use of the 36-month spreadback even though employment is uncompleted if the taxpayer qualifies under the 80% rule. Perhaps the easiest way to understand the nature of the Section's proposal is to look at the change they would make in the language of the Code. They would remove from current Section 1301 the matter in square brackets and add the italicized words. This section permits the spread of compensation if:

"(2) the employment covers a period of 36 months or more (from the beginning to the completion of such employment *or in the case of uncompleted employment, to the close of the taxable year*); and

"(3) the gross compensation from the employment received or accrued in the taxable year of the individual or partnership is not less than 80% of the total compensation [from] *received or accrued since the beginning of* such employment."

In explanation of how this change would work, the Section pointed out that "in the case of employment extending over a period of 36 months or more, if the gross compensation received or accrued in the taxable year is not less than 80% of the total compensation from the employment, existing law permits the compensation to be spread over that portion of the period of the employment which precedes the receipt or accrual of the compensation (Section 1301, IRC 1954).

"In the case of completed employment, the compensation due is generally precisely determinable, and it would be a rare case in which the right to spread, once apparently available, would be destroyed by subsequent developments. The case of uncompleted employment is different, however, in that events occurring after the (apparent) 80% year may render uncertain, or wholly destroy, the right to the spread.

". . . in the case of uncompleted employment, qualification under the 80% test is to be determined with reference to compensation received or accrued in the taxable year and prior years, and without reference to compensation received or accrued in subsequent years. Under the proposal, the right to spread is definitely established at the close of the taxable year.

"Operation of existing law, and the proposal, is illustrated by the following examples:

Case A

Compensation 1st year	20
Compensation 5th year	80
Compensation after 5th year	None
Total compensation	100

"Existing law permits the fifth year compensation to be spread, but the right to spread is not established until it is known that there will be no compensation after the fifth year. The proposal would not affect this result, but would establish the right to spread at the end of the fifth year.

Case B

Compensation 1st year	10
Compensation 5th year	80
Compensation after 5th year	10
Total compensation	100

"Existing law permits the fifth year compensation to be spread, but the right to spread is not established until the exact amount of the compensation after the fifth year is known. The proposal would not affect this result, but would establish the right to spread at the end of the fifth year.

Case C

Compensation 1st year	20
Compensation 5th year	80
Compensation after 5 year	10
Total compensation	110

"Existing law permits no spreading in this case; the after fifth year compensation destroys the qualification under the 80% test. The proposal would establish the right to spread at the end of the fifth year in this case."

Pre-1954 separation agreements

Another proposal would give spouses the right to elect to treat as alimony payments under pre-1954 separation agreements.

"Section 71 of the 1954 Code" the Section points out, "added a new provision including in the income of the wife periodic payments made under written separation agreements executed after the date of enactment of the 1954 Code. Such payments are deductible by the husband. The provision was not made applicable to separation agreements entered into prior to the date of enactment of the Code in order to prevent the possibility of upsetting arrangements which had theretofore been worked out with the understanding that the wife would not include the payments in her income. The proposal would make Section 71 applicable to preexisting agreements if both parties to the agreement elected to bring themselves within the new provisions."

Payments to disability funds

One small deduction which has been causing a vast amount of trouble quite out of proportion to its importance is the question whether an employee may deduct contributions, usually withheld from his pay, to state disability funds. Many of the states, for instance, New York, when they set up these systems, permitted employers to join either the state system or private insured plans. The Section says that, "from the standpoint of the employer, it would appear that deductions for contributions to such a plan should be allowed as ordinary and necessary expenses of the trade

or business, and that the allowance would not depend on whether the plan was a state plan or a private plan. On the other hand, from the standpoint of the contributing employee, a deduction would be available only if the contribution were paid as a tax. The contribution might constitute a tax under a state plan, but never under a private plan."

The Section would allow the employee a deduction no matter which system the employer used.

Contribution carryover for individuals

Section 170(b)(2) of the 1954 Code, the Section pointed out to the Ways and Means Committee, "allows a corporation which has made deductible gifts in excess of the 5% limitation in any one year to carry over the excess contributions as deductions to the two next succeeding taxable years, (to the extent that the 5% 'allowance' is not utilized in such succeeding years). The purpose of this provision is to prevent loss of all or a part of the deduction where a contribution is made early in the year in anticipation of substantial profits which are later wiped out or drastically reduced through unforeseen events, and also to minimize curtailment of corporate contributions in periods of reduced income. Yet this raises and leaves unanswered a conspicuous question . . . Why should the benefits of the amendment be confined to corporate taxypayers? The arguments offered in support of the amendment would seem to be equally pertinent in the case of individuals engaged in business as partners or sole proprietors, and are not peculiarly applicable to corporations alone."

The Section answers the question by proposing a two-year unused charitable contribution carryover for both corporations and individuals.

Estate planning expenses

"The question of recommending a statutory change to permit an individual to deduct estate planning expenses from his income for Federal income tax purposes has been considered before," the Section said.

"After considering the various approaches to the problem, the Committee has concluded that a change should be recommended permitting the deduction of estate planning expenses. Such legislation should be broadly drafted to include all aspects of estate planning and all legitimate costs and expenses incurred in connection therewith.

"The purpose of any such recommendation, if made, should be the clarification of an area of the law which has caused very substantial controversy between the Treasury Department and taxpayers, and has produced arbitrary results. It is difficult for any taxpayer to understand why the Treasury Department will presumably allow a deduction of the expenses incurred in connection with the creation of a revocable trust of income producing property, while it will probably deny a deduction for such expenses incurred in connection with the creation of an irrevocable trust, or the drafting of a will. In an involved overall planning for an individual, an attempted allocation between deductible and non-deductible expenses becomes arbitrary and often farcical.

"Section 212 of the 1954 Code expanded Section 23(a)(2) of the 1939 Code to permit an additional deduction by an individual for expenses incurred in the determination, collection or refund of any tax. Broadly construed, the new section might appear to be at least a partial solution to this problem. But, when the section is read in the light of the Committee Reports, it seems clear that such was not intended. In any event, a great deal of confusion and controversy will result unless there is clarification. Section 212(3), however, does represent a departure from the Treasury Department's underlying premise that the 1939 Code permitted deductions of non-business expenses only with respect to property which produced income for the taxpayer. The line drawn between permissible and non-permissible deductions under the 1939 Code was extremely hard to justify. The apparent line of demarcation in the 1954 Code is completely arbitrary. Proper planning for the management of property during life and its disposition after death are interrelated and nothing but confusion in the administration of the tax laws can result from attempts to draw such arbitrary distinctions under a provision as ambiguously worded as is Section 212.

"Since there has been an increasing tendency realistically to approach taxation from the standpoint of the burden that a family unit should bear, it appears proper to permit as an additional deduction to an individual all the expenses incurred in arranging for the disposition of his property during his life and after his death."

The language the Section proposes would allow the deduction of expenses "in connection with planning, arranging for, or making, by will, revocable or irrevocable trust, or otherwise, a donative or testamentary disposition of property or any interest therein, including proceeds of insurance, by such individual, whether or not such disposition becomes effective."

The Committee is aware that adoption of this proposal might lend some encouragement to the unauthorized practice of law, but is of the opinion that it would not be in the best interests of taxpayers or the bar to limit the deduction to attorneys' fees and expenses. If there is merit in the recommendation, it should apply to all legitimate expenses incurred by the taxpayer in connection with estate planning. The question of unauthorized practice of the law should not be injected into a taxing measure.

"It is to be noted that the words 'estate planning' do not appear in the suggested provision set forth above. There has been a studied attempt to avoid use of these words because their meaning is imprecise. While it is recognized that detail in a provision of this nature is generally undesirable, it was deemed necessary, and appropriate, to use some explanatory language in order to provide clarity in, and understanding of, the proposed provision."

Pre-death depreciation

The American Bar Association recommended to the Congress that the Code be amended to delete the requirement that the basis of property acquired from a decedent before his death but taking a new basis upon his death be reduced by depreciation or depletion, allowed to the taxpayer prior to the decedent's death. It said that,

"The provision requiring that the basis of property acquired from a decedent before his death which receives a new basis upon his death be reduced by the amount of depreciation or depletion allowed to the taxpayer prior to the decedent's death seems to proceed from the notion that the taxpayer will otherwise obtain excessive depreciation and depletion allowances. Since depreciation and depletion ordinarily are matched with an actual decline in the value of property, the death value of the property will reflect these allowances, and the use of such value without adjustment will not, in fact, give the taxpayer excessive deductions. On the other hand, the required adjustment would result, in sub-

stance, in denying to both the decedent and the donee the benefit of all depreciation and depletion on the property during the period of pre-death ownership by the donee." ☆

IRS encourages more economical do-it-yourself return filing

THE IRS is quite pleased with its progress in cutting the cost of aid to taxpayers in filing their returns. It encourages telephone calls rather than office visits and, for those who do come in, it tries to help the taxpayer complete his own return rather than prepare it for him. As a result, IRS is able to keep more employees on their regular duties and has less disruption to its schedules during the tax season. In his annual report for the year ended June 30, 1957, the Commissioner reported:

"Approximately 11,000,000 taxpayers were assisted in the preparation of their income tax returns during the annual filing period. This was a 7% decrease from the prior year and is due to the success of the publicity and educational programs of the Revenue Service to encourage taxpayers in "do-it-yourself" methods.

"More significant from the enforcement viewpoint were the savings in manpower effected during this year's filing period. Over 38,000 fewer man-days were required in the 1957 program than in the prior year's program, automatically increasing the personnel engaged in audit and other enforcement work by that amount.

"The cost of the assistance program this year was $3,260,000, considerably less than that of $4,040,000 in the preceding year.

"The results of the publicity and educational programs are indicated by the changing pattern in the type of assistance furnished. Although 6,000,000 taxpayers found it necessary to come to the field offices for help, this direct assistance decreased about 12% in the current program. On the other hand, the telephone question-answering service, which accounted for the remaining number of taxpayers assisted, increased slightly over the prior year. Continued expansion of the telephone service is expected since this type of assistance is the most convenient to taxpayers and the most economical to the government. During 1957, there were 117 taxpayers assisted per man-day by this method as compared to 108 taxpayers per man-day in the previous year.

"Fewer taxpayers received individual assistance in the preparation of their returns during the annual filing period than in the prior year's program. Personal assistance is given whenever necessary. However, expansion of the self-help methods is being encouraged.

"The self-help methods of assisting taxpayers in the completion of their returns have resulted in large savings of time and money to the Revenue Service. During 1957, 5 out of every 6 taxpayers assisted received this type of help as compared to 5 out of 7 in 1956." ☆

New decisions

No alimony deduction for payments made for childrens' support [*Certiorari denied*]. Taxpayer agreed to pay his ex-wife $125 per week and she would be responsible for the two children. Upon her remarriage, the weekly payments were to be reduced to $31.25 per child, and as each child attained the age of 21, $31.25 was to be eliminated from the payment. The Tax Court held the amount for the support of the children is identifiable and permits taxpayer to deduct only one-half of weekly payment as alimony. The Ninth Circuit affirmed. *Eisinger, cert. den.*, Sup. Ct., 3/17/58.

Payment of divorced wife's tax deficiencies alimony. The divorce decree provided that the husband was to pay his wife's income tax on the alimony he paid. He did not pay her anything under this provision for several years as the wife did not file returns during this period. When the wife was assessed the tax deficiency for the unreported years, the husband agreed to pay the tax. The IRS rules that the payment of the tax deficiency is alimony income to the wife and deductible by the husband. The payments to meet the additional income tax caused by the inclusion of the tax payments in the wife's income are also deductible by the husband and income to the wife. *Rev. Rul.* 58-100.

Doctor and wife can deduct 20% of Bermuda cruise expense. Taxpayer doctor and his wife attended a post-convention forum cruise to Bermuda sponsored by the American College of Physicians, and sought to deduct the entire cost as a business expense. Finding that the cruise combined business and pleasure, the court upholds the Commissioner's disallowance of 80% of the cost as a non-deductible personal expense. *Burnham*, TCM 1958-46.

Partner's gross income (for dependency test) is share of gross income of firm [*Acquiescence*]. Taxpayer's mother, who had other income of $500, was an equal partner with him in a business which had in 1952 gross profits of about $210 and a net operating loss of over $1,700. In determining the mother's gross income for purposes of qualifying her as a dependent, the court holds her share of the partnership's gross income must be taken into account. Since her gross income so determined exceeds $600, taxpayer is denied a claimed dependency credit for her. However, he is entitled to a deduction for medical expenses paid for her. It is not required that an exemption be allowed for medical expenses of a dependent to be deductible. For that the only tests are relationship and over half the support. [The 1954 Code specifically provides that gross income of a partner is his share of the gross income of the partnership.—*Ed.*] *Clark*, 29 TC No. 24. *Acq.* IRB 1958-13.

Interest on deficiencies arising out of business are business expense [*Acquiescence*]. In 1951 taxpayer arrived at a settlement of income tax deficiencies for prior years. He deducted in 1951 the full amount of the contingent legal fee for the settlement (only $1,500 was paid in that year) and the interest on the deficiencies (paid in 1952). The court holds that, since the deficiencies arose out of his lumber business, the legal fee and the interest are business expenses. The court finds that taxpayer was on the accrual basis so far as the business was concerned and it may deduct both these items even though they were not paid in the taxable year. *Standing*, 28 TC 789, *acq.* IRB 1958-11.

Expenses of European trip preparatory to establishing a business not deductible. An employed market research psychologist went to Europe to make contacts for his future business as an independent consultant. The trip was not related to any business. Expenses incurred on the trip are, therefore, not deductible. Furthermore, the cost of transporting his automobile to Europe cannot be taken as a deduction, even though he may have planned to sell it at a profit there, since the profit motive was en-

tirely submerged by the personal use which he in fact made of it. *Bell, Jr.,* TCM 1958-33.

Establishing business to obtain employment not deductible expenses. Taxpayer incurred expenses in an unsuccessful effort to have the City of Montreal, Canada, install a suspended monorailway transportation system. He also incurred expenses for the purpose of reactivating a National Hockey League franchise in Philadelphia. He claimed a deduction on the ground that, if either of these enterprises had been successful, he would be employed by them. The Tax Court disallows the deduction because amounts expended to establish a business so as to gain employment are not ordinary and necessary expense. The court notes that the question of a capital loss deduction is not before it. *Peto,* TCM 1958-34.

Casualty loss allowed for damages by a "mine cave." Damage to residential property caused by the collapse of mine excavations beneath the surface property results in a deductible casualty loss. *Rev. Rul.* 57-524.

"Conservative" claims for travel and entertainment disallowed in part. The Commissioner allowed $9,500 and $4,400 of a total of $15,600 and $7,000 claimed deductions for travel and entertaining expenses in two years. The Tax Court sustained this determination although it admitted the expenses were ordinary and necessary in taxpayer's trade or business and "conservative" in the light of the net profit. They are, nevertheless, disallowed in part because of lack of substantiation. *Five Star Dresses, Inc.,* TCM 1958-40.

Loans by employee to his company are non-business bad debts. Taxpayer was a commission advertising salesman for a magazine in which he owned 20% of the stock. A loss from worthlessness of advances which he made to the magazine is deductible only as a non-business bad debt since the advances were not proximately related to taxpayer's business as an advertising agent. *Sonz,* TCM 1958-30.

Hotel manager entitled to deduct travel and entertaining expense [*Acquiescence*]. A hotel manager received as additional compensation 5% of any increase he could bring about in the business of the hotel's catering department over that done in the corresponding month of the previous year. The court finds that under the arrangement it was contemplated that taxpayer would, if needed, expend funds of his own for entertainment and travel in promotion of the catering business and allows the expenditures proved. *Romer,* 28 TC No. 1228, *acq.* IRB 1958-11.

Iowa state employees can't deduct "tax" to finance their pensions. A so-called Iowa "tax" imposed on public employees as a contribution to a state retirement fund is not deductible by an employee as a tax, but is his cost of the retirement annuity provided for by the Iowa law. *Rev. Rul.* 58-141.

Can't deduct legal fees to avoid criminal tax prosecution. Taxpayer's partnership retained a firm of attorneys to defend him against possible criminal tax liability. Taxpayer was indicted for tax evasion, but subsequently had a heart attack and was never brought to trial. Thereafter taxpayer paid the civil tax liability and also fraud penalties. The same firm of attorneys represented taxpayer throughout the criminal and civil proceedings and was paid a fee of $22,500 by the partnership. The court holds that the fee was not an ordinary and necessary expense of either the partnership or the partners. *Brinson,* DC Fla., 3/18/58.

Foreign trips were personal, not business, expenses. The Detroit Board of Commerce sponsored cruises for its members each year. Taxpayer, who was in the blueprint business, took a Far East cruise one year and a Mediterranean cruise the next. The court finds these trips were primarily recreational. The business aspects, if any, were incidental. Deductions are disallowed. *Hardy,* DC Mich., 3/11/58.

New Regulation allows expenses for education. Regulation Section 1.162-5 sets forth in considerable detail the IRS' new position on allowable expenses for education. They are allowable if they maintain or improve skills required in taxpayer's trade, business or employment or are required as a condition of retaining employment. The expenses are not deductible if incurred to obtain a new position, a substantial advance, or for personal reasons or to further general education. If the expenses of education are deductible, travel, meals and lodging away from home to obtain it are likewise deductible. T.D. 6291.

Occasional gambler can't take deduction for gambling losses. Taxpayer who gambled "occassionally" failed to keep records of his gambling wins and losses. For failure of proof the Commissioner's determination of his winnings for 1948 was sustained. As taxpayer was not in the business of gambling, he was not permitted to deduct gambling losses in arriving at his adjusted gross income. Neither could he take the gambling losses as a deduction from adjusted gross income since he had elected the standard deduction on his 1948 return and was precluded from revoking such election. [For taxable years after 1949, the election may be changed at any time within the statute of limitations.—*Ed.*] *Hixon,* CA-2, 3/25/58.

Subsistence allowances of state-highway patrolmen are additional compensation (Old Law) [*Certiorari denied*]. Taxpayer, a member of the Georgia State Patrol, was required to live in a barracks and was on call 24 hours a day. He received a subsistence allowance of $4.50 a day to defray the costs of his meals, which he ate at restaurants on his route. The Tax Court held this taxable as additional compensation. This court affirms. The "convenience of employer" rule is inapplicable; it was argued that, if the state supplied meals, the patrolmen would all be off-duty at the same time. The court cannot find that taxpayer's eating of meals in a restaurant of his choice, paid for from the subsistence allowance, should result in favored tax treatment denied all other employee-taxpayers who eat one or more meals away from home. [Under the 1954 Code, meals and lodging for the convenience of the employer are excluded, whether or not they are compensation. But this applies only to meals eaten on the business premises.—*Ed.*] *Magness, cert. den.,* 1/27/58.

Cabot prize not income. The Maria Moore Cabot prize, awarded in recognition of outstanding public service in journalism, including the $1,000 cash given the recipient or his representative to appear personally to accept the prize, is excludible from the recipient's gross income. The recipient of the award does not enter a contest, nor is he required to render future services. *Rev. Rul.* 58-89.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

Basic rules on tax liability of U. S. citizens earning income abroad

by MARCELLUS R. MEEK

When a U. S. citizen first earns income abroad, he is confronted with some rather technical rules setting forth tax benefits he may obtain. These rules relate to a credit for foreign taxes paid, to exemption from U. S. tax in certain circumstances and to other special deductions. This article is a concise statement of the underlying rules and should be of particular interest to practitioners who may be required for the first time to advise clients on foreign tax matters.

WHEN IT IS PROPOSED that a particular employee, because of his special skills, be sent abroad for any great length of time, the first question raised by that person is, "What do I do about my United States taxes?" This article attempts briefly to answer some of the more general inquiries that arise.

To begin with, U. S. tax law is extra-territorial in application. A U. S. citizen is taxed on his income from whatever source derived. Relief is granted, however, in the form both of a foreign tax credit and a complete exemption of earned foreign-source income.

Credits and exemptions

Section 901(b) provides that, if a U. S. citizen is taxed by a foreign country on income which is also taxable in the U. S., a credit will be allowed against the U. S. tax for the foreign taxes paid.

As an alternative to the foreign tax credit, complete exemption of earned income from U. S. taxes may be had under certain conditions. Two methods are provided for obtaining these benefits under Section 911 of the 1954 Code. One is by establishment of bona fide residence abroad. The other is by physical presence abroad for seventeen out of eighteen months.

Sec. 911(a)(1) provides exemption to U. S. citizens who are bona fide residents of a foreign country for an uninterrupted period which includes an entire taxable year. Such residence is a matter of intent and is based upon all the facts and circumstances present. If a U. S. citizen goes to another country intending to reside there and has set no specific time for his return, and if there are present the usual indicia of residence, such as a home and family, there will be little question that he has established a residence in such place.

After this "bona fide residence" status is established, a citizen can return for temporary visits to the U. S. without endangering the exemption of his foreign earned income. Of course, too much time spent in the U. S. might be evidence that the citizen was not a bona fide resident of the foreign country or that, once having attained that status, he has relinquished it.

An important case in this connection is *White vs. Hofferbert* [1950 88 F. Supp. 457], in which it was held that, once bona fide residence abroad is established, occasional business trips to the United States have no effect on residence. In this case, the petitioner was assigned in December of 1942 to Sweden, where he resided until February of 1944, at which time he was transferred to Spain. While in Sweden, he was unable to have his wife and daughter with him because of the war, but they were able to join him in 1945 in Spain. During his residence abroad, he returned for business conferences on several occasions. On March 15, 1944 the petitioner returned to the United States and remained until July 22 of that year (slightly over four months). Again in November of 1944 he returned to the United States and did not return to Spain until June of 1945. In January, 1946, he left his wife and daughter in Spain and returned to the United States for less than a month. He took a vacation to the United States in July, 1946, until September, 1946. In January, 1947, he was transferred to the New York office and later took up residence in Baltimore, where his family home was located. He never paid Swedish or Spanish income taxes, but filed U.S. income tax returns in 1944 and 1945 and included the proportion of income he earned while in the United States as United States income and paid the appropriate U. S. taxes.

The court held that, although the petitioner was domiciled in Baltimore, he was a bona fide resident of Sweden and Spain during the three years. The court said:

"While his period of actual physical stay in the United States both in 1944 and 1945 was quite considerable (not quite six months for either year), it is clear that the absences from the foreign countries were for urgent business reasons in no way due to the volition of the taxpayer. His original engagement as a foreign service officer of the I.T.&T. in November, 1942, was for an *indefinite period,* and it is entirely reasonable to assume that his intention was to remain in the foreign service of that company as a career or at least for many years."

Thus, repeated and even extensive trips to the United States will not constitute an abandonment of foreign residence, so long as there is no intention on the part of the United States citizen to reside in the United States for any great length of time. In *Seeley* [186 F. 2d. 541], the residence abroad was broken when the employee was brought back to the U. S. and worked on two U. S. jobs and then returned to a different foreign country.

The first year

Some question has arisen as to whether the employee may return to the U. S. on business or pleasure during the first year of his residence abroad. The answer to this question is yes. The *Page*

[24 TC 52 (1955)] case is squarely in point. In that case, the petitioner formed the intention to "reside" in Buenos Aires, Argentina, in October of 1947 and returned to the United States in November of 1947 to arrange for the transfer of his belongings and to pick up his family. He returned to Buenos Aires in February of 1948. The court held that he established bona fide residence in Argentina in October, 1947, despite the fact that he returned to the United States.

The court said:

"We are convinced from the evidence that in October, 1947, he then formed an intention to be an Argentine resident. The intention plus his physical presence where he had a job for an extended stay is sufficient to meet the "bona fide resident" requirements of section 116(a) of the Code, and the corresponding regulations. [*Leonard Larsen,* 23 TC 599.] We cannot find that the short trip to the United States in the latter part of 1947 interrupted his Argentine residence so as to preclude him from the benefits of Section 116(a) for the year 1948."

Similarly, it was held in *David E. Rose* [16 TC 232 (1951)], that visits to the U. S. would not deprive the petitioner of his foreign residence. In that case, Mr. Rose had a contract of employment as managing director of Paramount Pictures' subsidiaries in the United Kingdom. This contract was conditioned upon the fact that Mr. Rose was to move to and reside in England. He relinquished his California apartment and rented an apartment under a five-year lease in London. On August 11, 1938, he left for England intending to make his residence there indefinitely. He remained until 1946. His wife and child returned in 1939 upon the outbreak of war. He returned twice a year to visit his family, report to his employers and receive instructions. In August of 1945 his wife and child returned to England and the child went to school.

The court held that Rose was a bona fide resident of England and quoted the language of the Senate Finance Committee that:

"Vacation or business trips to the United States during the taxable year will not necessarily deprive a taxpayer, otherwise qualified, of the exemption provided by this section," [Sen. Rept. No. 1630, 77th Cong. 2nd Sess. (1942) and later embodied in Reg. 111, 29.116-1.]

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Filing U. S. tax returns

If a United States citizen begins the foreign residence during the course of the taxable year, he will qualify for the exemption under Sec. 911(a)(1) for that year if he subsequently remains a foreign resident for the next tax year. [*Rev. Rul.* 55-171, CB 1955-1, pp. 80, 90.] The taxpayer will not have qualified for the exemption when the time comes to file his return covering the year during which he changed his residence, since he will not have been a resident for the uninterrupted period of one tax year.

To meet this situation, the Regulations, Sec. 1.911-1(b)(3), permit the district director to grant an extension not exceeding six months. In order to secure an extension, a letter should be addressed to the district director disclosing the facts which will eventually qualify the taxpayer for the exemption and the date on which he will be in a position to claim the exemption. This letter should be sent before the date on which the return is due.

As an alternative to obtaining an extension, the United States citizen can pay the U. S. tax on the foreign earned income of the first year and then file a claim for a refund at the end of the next full year of residence abroad.

The 510-day physical presence test

Under Section 911(a)(2), if a U. S. citizen is physically outside of the United States for 510 full days during eighteen consecutive months, earned foreign-source income is exempt to the extent of $20,000 per year. If only a portion of a taxable year is included in the eighteen-month period, the maximum amount excludible is limited to an amount which bears the same ratio to $20,000 as the number of days the taxpayer is outside of the United States bears to 365.

A full day has been construed to mean a twenty-four hour period from midnight to midnight. Time spent in traveling from the United States to foreign countries and from foreign countries to the United States is not computed as part of the required 510 days, since the taxpayer is not physically present in a foreign country while in transit. Furthermore, if more than 24 hours are spent in traveling over international waterways between foreign countries, the time is not counted. [*Rev. Rul.* 55-171, IRB 1955-13.9.]

A U. S. citizen who has earned foreign-source income exempt from U. S. taxes under Section 911 may conceivably have U. S. income-tax liability on other types of income. And in this regard, Section 911 expressly states that no deductions other than Section 151 personal exemptions ($600 for the taxpayer, $600 for a spouse, and $600 for each dependent) can be deducted from income not exempt under that section unless it is properly allocable to it.

Neither the place of payment nor the domicile of the payer will affect the grant of exemption. The question is determined by whether or not the salary is paid in respect of services performed abroad or in the United States. It is immaterial that payment is made by a domestic corporation or that payment is made in the U. S. by deposit to a bank account here.

No U. S. taxes need be withheld if it is reasonable to believe that the income will eventually qualify for a Section 911 exemption, or if a tax is being withheld on behalf of a foreign country. The exemptions granted by Section 911 apply, however, whether or not any foreign taxes have been paid. [*White v. Hofferbert, David E. Rose, supra.*]

Pension payments may or may not be exempted from United States tax depending upon the source from which they are paid. If future pension payments are made from the current operating funds of the company, that portion of the payments allocable to services performed while a nonresident will be tax free. [*Rev Rul.* 55-294, CB

BETTERMENT PROGRAM

IT IS MY feeling that, during the waiting period for substantial relief in the total tax take, we should in some way reduce the high punitive surtax rates, because I believe we can prove that that is not a revenue matter in a broad sense. Moreover, we should improve the tax structure in other ways where it can be demonstrated that revenue is not importantly involved. . . . *Geo. S. Koch,* Manager, Tax Department, Standard Oil (N. J.), at the 13th National Tax Conference of the Tax Foundation.

1955-1, p. 398.] If the payments are made from a funded pension plan qualifying under Section 401, the same may not be true.

Conclusion

As we have stated, the foregoing is intended to serve as a general guide, rather than an exhaustive study of the subject matter. Special problems will arise for United States citizens living abroad, the answers to which will not appear in these pages. It is hoped, however, that the statement of general principles above and the presentation of factual circumstances will aid to form a basis upon which further individual study can be predicated. ☆

Bar group recommends limitations on foreign tax credits; defines WHTC

THE LEGISLATIVE RECOMMENDATIONS of the American Bar Association's Section on Taxation are always an informative national cross-section of the thinking of tax advisers. The 1957 recommendations included several that relate to foreign taxation.

The Association recommends that the Code be amended so that the statute of limitations would be extended to give a right to change the election between a deduction or a credit for foreign taxes with respect to any year which remains open for the purpose of computing a carryback of net operating losses.

The suggestion is that Section 6511 (d)(2)(A) (relating to limitations with respect to net operating loss carrybacks) is amended to read as follows (add new matter in italics):

"1. Period of limitation.—If the claim for credit or refund relates to an overpayment attributable to a net operating loss carryback, *including an overpayment resulting from an election to deduct foreign taxes paid rather than to take credit therefor in the computation of an overpayment attributable to a net operating loss carryback,* in lieu of the three-year period of limitation prescribed in subsection (a), the period shall be that period which ends with the expiration of the 15th day of the 39th month following the end of the taxable year of the net operating loss which results in such carryback, or the period prescribed in subsection (c) in respect of such taxable year, whichever expires later . . ."

The Taxation Section explained that, under the Code, the right to change an election to take credit or deduct foreign taxes in connection with a year in which a carryback of net operating loss deduction is being computed is not clear.

The Association recommends the repeal of Section 6046 which contains the requirement that persons assisting in the formation or reorganization of foreign corporations must file an information return.

Section 6046 requires a report to be made with respect to the formation or reorganization of foreign corporations. However, the Section stated, it contains an exemption in respect to confidential disclosures to attorneys. Investigations indicate that the reports required under this section have been little used by the IRS. Initially, it was believed that the reports furnished statistical data, but they are not being so used. Moreover, if they were, statistical data would, of necessity, be inaccurate because of the exemption for confidential disclosures. Finally, there seems little justification for these reports which do not bear upon tax liability of the person submitting the report, or upon the tax liability of the person receiving payment from the submitter.

Definition of WHTC

The American Bar Association recommends that the Code be amended to provide that, in determining whether a corporation qualifies as a Western Hemisphere trade corporation, purchasing activities outside of the Western Hemisphere should not be taken into account. This problem was discussed in an earlier issue (8 JTAX 172). This would be accomplished by eliminating the word "incidental" in the definition of Western Hemisphere trade corporation in Section 921 as follows (eliminate the matter in square brackets):

"For purposes of this subtitle, the term 'Western Hemisphere trade corporation' means a domestic corporation all of whose business (other than [incidental] purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions: . . ."

The Section explains that the Western Hemisphere trade corporation concept was enacted to encourage United States capital to invest in the Western Hemisphere outside of the United States and to put United States capital in that area on a competitive equality with foreign capital. Allowing purchases to be made outside of the Western Hemisphere by a Western Hemisphere trade corporation would seem necessary to effectuate these policies.

Further, the present statute can be circumvented through the use of a non-Western Hemisphere trade corporation to make purchases outside the Western Hemisphere followed by a resale on proper terms to the Western Hemisphere trade corporation; it should be unnecessary to adopt such a procedure.

New decisions

Intention alone not sufficient to establish domicile for estate tax purpose. The decedent, a non-resident alien, had visited the United States as a tourist several times during the last years of his life. Shortly prior to his death he secured an immigration visa in order to establish permanent residence. He returned to Europe shortly thereafter, however, where he died. The Service rules that, although the decedent may have formed the intent of establishing a domicile in the United States, his course of conduct was not sufficient to effect a change of domicile to the United States for estate tax purposes. *Rev. Rul.* 58-70.

Alien in U. S. military training not resident. An alien serving in the U. S. army, who is present in the U. S. for a six months' period for military training, is taxed as a non-resident alien. While such an individual may be classified as a resident immigrant for citizenship purposes, for tax purposes he remains a non-resident alien engaged in trade or business in the U. S. Only his army pay while in this country is taxable income. [Resident aliens are in general taxed like citizens, i.e., on all income; non-resident aliens are in general taxed only on income from U. S. sources, including earnings here.—*Ed.*] *Rev. Rul.* 58-144.

NEW DEVELOPMENTS IN

Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

The IRS year: delinquency collections up, fraud investigations down

THE IRS IS ACTING more quickly against delinquent taxpayers, assigning them to field collection offices after only one notice. As a result, it reduced its backlog of delinquent accounts as of June 30, 1957, despite an increase of new ones during that year. This is the second year the inventory decreased.

"Although the reductions were small," the Commissioner said in his annual report, "they were of major significance in contrast to decades of steadily rising backlogs of overdue taxes.

"The reductions were the result of a top priority program calling for concentrated and vigorous action in the delinquent accounts area. At the end of June 1957, the inventory of delinquent accounts comprised 1,488,000 cases, or a drop of 1.1% from the 1,505,000 cases on hand on June 30, 1956. Dollarwise, inventory dropped by 1.7% from $1,588,008,000 to $1,560,530,000.

"The decrease in inventory during 1957 was achieved despite the fact that there was a marked increase in issuances of delinquent account notices during the year as compared with the preceding fiscal year. During 1957 a total of 2,744,000 delinquent account assemblies was issued. An 'assembly' is a set of form notices used in following up and recording a delinquent account. There were 437,000, or 19%, more assemblies issued than during 1956. The amount of tax in these cases aggregated $1,299,176,000, an increase of $217,063,000, or 20%, over the amount during 1956. The increase continued to reflect an accelerated program aimed at earlier contact with the delinquent taxpayer. In prior years, the Revenue Service's policy called for the issuance of a first notice, followed by a second notice, and subsequent assignment of the case to the field collection force if payment was not forthcoming as a result of the notices. During 1956 the second notice was discontinued. First notices were promptly issued on accounts which showed tax payments to be due. If such payments were not made within the prescribed period, the delinquent accounts were assigned for special collection action.

Better use of personnel

"An important factor in the 1957 achievements was the program instituted throughout the Revenue Service calling for a strengthened office collection force to handle the newer and relatively simpler accounts, thus permitting the collection officers to concentrate on the more difficult and the older cases. A total of 2,762,000 delinquent accounts involving $1,321,108,000 was closed during the year, as compared with 2,360,000 accounts aggregating $1,152,531,000 which were closed in 1956.

"During 1957, 85% of all accounts closed were by collections. This method accounted for 82% of closings in 1956. Dollarwise, collections continued to represent over 71% of all closings.

Delinquent returns

"An increase in the number of delinquent returns obtained and in the amount of tax from such returns was achieved in 1957 in spite of the fact" the Commissioner said, "that it was still necessary to give first priority on the time of collection officers to the collection of delinquent accounts, as described in the preceding section.

"However, as district offices improved the condition of their delinquent account inventories, it was possible for them to devote somewhat more effort to the constant lookout for occasional persons or firms who have failed to file required returns.

"The vast majority of these delinquent returns were quarterly payroll and excise tax returns. Only a small percentage were annual income tax returns."

Fraud investigations

"The number of full-scale investigations was about the same as the year before; the additional taxes and penalties involved in these cases were 23% above the previous year. The number of prosecutions recommended in tax cases (other than tax on wagering and coin-operated gaming devices) rose from 1,368 in the fiscal year 1956 to 1,399 in the current year, an all-time high.

Tax fraud and other investigations completed by Intelligence Division

Type	*Fiscal year— 1957*	*1956*
Grand total	30,438	34,886
Suspected fraud and miscellaneous type cases investigated:		
Unnumbered (preliminary) investigations, total	17,759	24,121
Fraud	14,888	19,874
Wagering	2,082	2,474
Coin-operated gaming devices	620	1,631
Miscellaneous	169	142
Numbered (full-scale) investigations, total	4,538	4,650
Prosecution recommended:		
Fraud	1,399	1,368
Wagering	603	734
Coin-operated gaming devices	241	235
Miscellaneous	28	42
Prosecution not recommended:		
Fraud	1,290	1,346
Wagering	73	99
Coin-operated gaming devices	141	55
Miscellaneous	24	10
Investigations discontinued:		
Fraud	701	689
Wagering	30	65
Coin-operated gaming devices	8	7
Other investigations, total	8,141	6,115

Receipt and disposal of cases in Chief Counsel's Office

Status	Fiscal year— 1957	1956
Pending July 1[1]	3,140	3,377
Received during year, total	2,174	2,318
With recommendation for prosecution	2,106	2,215
With requests for opinion	68	103
Disposed of during year, total	2,174	2,555
Prosecution not warranted	230	208
Department of Justice declined to prosecute[2]	257	336
Prosecutions	1,412	1,769
Opinions delivered	72	114
All other closings	203	128
Pending June 30[1]	3,140	3,140

[1] Includes cases awaiting action in Department of Justice.
[2] Includes 137 wagering tax cases during 1957 and 191 during 1956.

"The number of all types of investigations completed by the special agents decreased from 34,886 to 30,438 due principally to the decreases in unnumbered (preliminary) investigations and numbered (full-scale extensive) investigations of wagering tax violations.

"Unnumbered (preliminary) investigations represent inquiries to determine whether prospective cases warrant full-scale numbered investigations. The decrease in this case category is not significant because the number is subject to wide fluctuations dictated by whether agents can be spared from work on numbered cases, and also by the varying seriousness of the allegations to be evaluated. A more effective screening of such allegations was emphasized during the year, which permitted earlier disposition of matters having questionable prosecution potential, thereby eliminating the need for unnumbered investigations in many instances. In emphasizing better initial selectivity of cases, recognition has been given to the continuing necessity for individual inquiries and surveys to broaden the enforcement area.

"Greater uniformity in the application of investigative techniques and in the processing of Intelligence cases has been stressed in meetings of Intelligence group supervisors with National Office technicians which were initiated during the year. This emphasis will be continued in the future."

Criminal prosecutions

"The number of income and excise tax cases prosecuted increased sharply last year, in line with the trend of recent years," the Commissioner reported.

"A total of 1,825 cases of all kinds was forwarded to the Department of Justice with recommendations for criminal proceedings against 1,919 prospective defendants. This represents a reduction of about 7% from the number of cases referred during the preceding year, and such decrease was confined primarily to the number of wagering tax cases.

"Indictments in income, estate, gift, and miscellaneous excise tax cases, exclusive of wagering, alcohol, tobacco, and firearms tax cases, rose from 831 to 1,104, an increase of 33%.

"In income, excise, and wagering tax cases reaching the courtroom, 1,118 defendants pleaded guilty or nolo contendere, 138 were convicted after trial, 64 were acquitted, and 289 were dismissed. In alcohol, tobacco, and firearms tax cases, 4,873 pleaded guilty, 880 were convicted after trial, 365 were acquitted, and 643 were dismissed." ☆

New fraud and negligence decisions

Gambler's returns fraudulent. A net worth investigation of taxpayer by the revenue agents disclosed four principal sources of unreported income—gambling, bookmaking, manipulation of parimutuel funds, and various legitimate enterprises. Taxpayer kept no books and records, had two safety deposit boxes in fictitious names, and had been convicted for wilfull tax evasion for two of the years in issue. Absent any evidence on taxpayer's part, the deficiencies as determined are approved for lack of prosecution and failure of proof. Fraud penalties are upheld. *Lewis,* TCM 1958-23.

Doctor's returns fraudulent. Decedent, a doctor, failed to report substantial professional earnings for the years 1944-1950, as evidenced by net worth computations, and also failed to reveal to the examining agents that he had accumulated cash in 37 different savings banks totaling over $120,000. The court upholds the deficiencies and finds the returns false and fraudulent with intent to evade tax, so that the statute of limitations was no bar to the assessments. *Est. of Schneider,* 29 TC No. 100.

Commissioner can examine records after issuance of deficiency. After the Commissioner issued a deficiency notice for 1952, he requested certain vouchers, checks and invoices relating to equipment for 1950 and 1951. Taxpayer's attempt to prevent this examination failed. The Commissioner was not examining prior years twice; he was seeking evidence on which 1952 depreciation was based. Now the taxpayer argues that the Commissioner can't examine '52 after the '52 deficiency notice is issued. The district court saw no merit in this argument. The Commissioner may request the Tax Court to increase the deficiency; he is therefore permitted to look for additional evidence. This court affirms. *Norda Essential Oil & Chemical Co.,* CA-2, 1/31/58.

Fraud not proved by lack of evidence *[Acquiescence].* Both sides presented evidence as to the other years in issue, but neither side presented any evidence as to 1949. The Tax Court therefore found for the Commissioner as to the assessed deficiencies, but for the taxpayer as to the fraud penalties. *Funk,* 29 TC No. 32, *acq.* IRB 1957-11.

Taking personal expenses as business is proof of fraud. The officers of taxpayer corporation had their personal expenses (including the family servants' payroll) charged to the corporation under various misleading headings. However, the statute of limitations would prevent assessment of the corporation unless this conduct is deemed fraudulent. The court finds it was fraudulent and holds that the statute of limitations is not a bar to the assessment. While the conduct of the officers might not be criminal, it amounts to civil fraud. The fact of concealment of the expenses under misleading accounts is strong evidence of fraudulent intent. *Frank Fehr Brewing Co.,* DC Ky., 3/5/58.

Commissioner not estopped from conducting a re-examination; fraud penalties upheld. The Commissioner computed taxpayer's income for 1943-1947 by the net worth method. Taxpayer did

not contest the deficiencies, but contended that it was invalid because the Commissioner had already examined the years in question and failed to comply with the Code provisions relating to the giving of written notice prior to a re-examination. The court overrules taxpayer's contention, holding that his failure to make a timely objection to the re-examination constitutes a waiver of the protection afforded by the statute. The net worth computations show that taxpayer consistently reported less than ⅓ of his taxable income. This, coupled with the fact that the available books and records had been altered, and that taxpayer had been convicted on a charge of income tax evasion, is sufficient evidence to support the fraud penalties. *Cefalu,* TCM 1958-37.

Lawyer's income reconstructed by net worth. The Commissioner determined on the basis of a net worth computation that taxpayer, a lawyer, failed to report over $100,000 during the years 1944-1950. Taxpayer had destroyed his records for 1944-48 and had inadequate records for 1949 and 1950. The court sustains the Commissioner's net worth computation. In the light of the substantial under-reporting of income, the court also finds that the deficiencies were due to fraud. *Shahadi,* 29 TC No. 122.

Reconstructing income by bank deposit method improper; deposits came from prior savings [*Acquiescence*]. Taxpayer's only source of income during the taxable years was from a watch business for which he kept adequate books and records reflecting all transactions. The Commissioner's reconstruction of taxpayer's income by use of bank deposits is held to be improper particularly since taxpayer offered proof that the "unexplained" deposits were made from funds brought with him when he emigrated to the U. S. in 1933. The fraud penalties are rejected. *Damski,* 29 TC *acq.* IRB 1958-13.

Dealer's returns did not agree with reports to GM; guilty verdict upheld. On appeal from his conviction for willful evasion, taxpayer argued that it was not enough to show that he returns did not agree with his books; the books must be shown to be correct. The court holds the jury justified in accepting the books; they were kept under the system prescribed by Pontiac for its dealers and were obviously designed to reflect true income. Furthermore, taxpayer submitted detailed signed statements to GMAC in connection with his financing of cars sold. The differences between the books and the returns, immediately obvious to the examining agent, were apparently explained as due to write-downs of the inventory of used cars, generally overstated in the sale so as to meet wartime credit controls. The court saw no justification for this in view of the reduction to market already made on the books. *Moore,* CA-5, 3/18/58.

Fraud penalties against farmer sustained in part and reversed in part. The Tax Court upheld fraud penalties against taxpayer, a farmer, for the years 1947 through 1950, based on net worth computations. This court modifies the net worth computation to deduct outstanding checks from the bank balance at the end of each year. It also reverses as to 1947 because part of the unreported deposits of that year may have been the share of his tenant farmers; the evidence of fraud as to that year was insufficient to sustain the Commissioner's burden. *Clark,* CA-3, 3/13/58.

Omission of over-ceiling prices from income fraudulent. The evidence disclosed that taxpayers received cash premiums during 1946 for sugar sold during OPA. The court holds their failure to report these illegal receipts was done with an intent to evade taxes and imposed fraud penalties. *Sandler,* TCM 1958-47.

IRS must show reasonable basis before it can examine closed years. The Government sought to examine taxpayer's 1943 to 1947 tax returns at a time when all years were closed unless the returns were fraudulent. There was no showing in the district court that the Government had probable cause to believe taxpayer's returns were fraudulent. It is not enough that the examining IRS agent believed the returns fraudulent. The court refuses to allow examination. The Government must show a reasonable basis for its suspicion. The court admits that most of the decided cases do not require a showing of probable cause. *O'Connor,* CA-1, 3/20/58.

Criminal conviction for failure to obey IRS summons. Taxpayer, a furrier, admitted to IRS agents he was evading excise taxes, but told them, "Run along, boys. Have your fun." The IRS replied with a summons to produce taxpayer's books and records. Taxpayer claimed that they had been destroyed in a fire. Subsequently, in response to a grand jury subpoena, he produced the books and records. Taxpayer is now being criminally prosecuted for failure to obey the IRS summons. The court finds him guilty. Taxpayer's defense that he thought the books had been destroyed by fire is insufficient as examination of the evidence shows that taxpayer made no real attempt to ascertain whether there were any books or records. *Becker,* DC N. Y., 3/25/58.

NEW DECISIONS INVOLVING EXEMPT INSTITUTIONS

Kress allowed unlimited charitable deduction. The Code allows an unlimited charitable deduction to an individual who has given 90% of his income to charity in the ten preceding years. Taxpayer's contributions to charity met this requirement if his long-term capital gains are income only to the extent that is recognized (50%). The court holds for the taxpayer. It is settled that the income limitation for the purpose of a trust's income is computed by reference to the taxable percentage of capital gains. There is no reason that the same rule should not apply here. As to the 1938 taxable year, taxpayer's charitable contributions for that year would qualify unless the 1939 law change retroactively increased taxpayer's income for 1938 and his contributions were less than 90% of the final income. The court holds the retroactive change should not be interpreted as destroying taxpayer's qualification as a 90% donor. *Kress,* Ct. Cls., 3/5/58.

Labor union paying death and sick benefit plan may lose exemption. The Service takes the position that the operation by a labor union of an established system for the payment of sickness, death, accident and other benefits, which members are entitled to receive as a matter of right in consideration of the payment of assessments, may cause a withdrawal of its exempt status since the operation has no relation to the customary purposes of a labor union within the contemplation of Section 501(c)(5) granting such exemption. It recommends that a formal trust arrangement or other form of organization through which the benefits are to be paid be set up as a separate entity, apart from the union. *Rev. Rul.* 58-143.

NEW DEVELOPMENTS IN

Taxation of oil & gas

EDITED BY GODFREY WM. WELSCH, LL.B., CPA

New edition of Miller's Oil and Gas Income Taxation out

IN THE MOST recent revision of his authoritative work,* Kenneth G. Miller has produced a book which should prove indispensable to the oil and gas tax practitioner. While there is no doubt that the book will appeal to the technician because of its thorough documentation of the law, regulations and court decisions, it also should be accepted with enthusiasm by the layman who is faced with day-to-day business decisions in the oil and gas field that must include tax considerations.

The prior editions were occasionally subject to some criticism on the ground that they tended to rely too heavily on direct quotations from the Regulations, decisions, etc. In the current edition Mr. Miller, recognizing that his readers are seeking an independent appraisal with respect to the various issues and principles involved, has introduced a new and welcome feature. Through use of author's notes he expresses his own opinions, acquaints the reader with accepted practices and discusses subjects which are void of cases or published rulings.

For example, the production of gas has given rise to many problems which have not been the subject of published rulings or decided cases. In the chapter which explores the depletion deduction, Mr. Miller gives his own views on problems associated with borrowed gas, stored gas and repressure gas. In discussing a drilling "deal" wherein the sublessor of the entire working interest retains an overriding royalty with an option for future exchange of the retained royalty for part of the working interest, the author points out that the Service may view such an exchange as a taxable event.

In logical order such areas as the property for depletion purposes, gross income from the property, taxable income from the property and restoration of depletion are fully explored. Partnerships, associations and unitizations also are covered. The author, who is also editor of the *Oil & Gas Tax Quarterly*, has drawn on his wide experience to present his readers with a comprehensive treatise on oil and gas taxation.

It is recognized, of course, that the subject is a dynamic one and that long-accepted principles may be upset by law or judiciary action. The current edition incorporates all recent developments through the date of publication (May, 1957). Although handicapped by the lack of final 1954 Code Regulations on the natural resource sections, the author felt that the revised edition should not be delayed any longer in view of significant developments which had taken place since the release of the second edition. To compensate for this unavoidable gap in the current edition, a free supplement will be available to purchasers which will contain the text of the final Regulations when they are issued. ☆

* Oil and Gas Federal Income Taxation, by Kenneth G. Miller, Commerce Clearing House, Chicago, Ill., 3rd Ed. 1957, $10.50.

New decisions affecting special industries

Bank's addition to bad debt reserve unaffected by carryback from later loss year. The Code limits the addition to bad debt reserve of certain mutual savings banks, building and loan associations, etc., to their net income for the year before this deduction. The IRS is here asked to rule upon the proper treatment of the 1955 deduction by a bank which in 1955 had a small profit, eliminated when it claimed the same amount as an addition to its reserve. In 1956 it had a substantial loss which is a carryback to 1955. Should the addition to the reserve in 1955 be reversed because the 1955 income is wiped out by the carryback even without the deduction for the increase in the reserve? The IRS rules that the 1955 addition must stand as a deduction in 1955 unaffected by the 1956 loss; if the addition was reasonable and proper, then in 1955 it cannot be changed because of events happening later. *Rev. Rul.* 58-10.

Economic interest in coal found; taxpayer may claim percentage depletion. Taxpayers acted as one of several contractors who did the actual mining for a coal land holder. Taxpayers mined coal and delivered it at a prearranged price for further processing. Taxpayers invested in movable machinery and the costs of opening and operating the mine. They had no right to mine a fixed quantity of coal or coal in a fixed location and the contract was terminable by either party at will. The district court held that taxpayers did not acquire an economic interest in the mineral, hence they are not entitled to a percentage depletion allowance. This court reverses. Although the agreement was terminable at will, the conduct of the parties and the substantial investment of the taxpayers indicates the arrangement was permanent, and the taxpayer had an economic interest in the coal. *Stilwell*, CA-4, 12/27/57.

Can't depreciate breeding herd included in inventory. Taxpayers, who were sheep ranchers, had been computing their net income by including their breeding herd in inventory. They asserted the right to depreciate certain of the purchased breeding livestock for the first time when their return for the taxable year was being audited. The court denies any right to depreciation, pointing out that once having made the election to inventory purchased breeding livestock, they are bound to apply the chosen method (treating the livestock as non-capital assets subject to depreciation) until the Commissioner approves of such change. *Elia*, TCM 1957-238.

Right to separate natural gas an economic interest; depletion allowed. Taxpayer's contract with leaseholders in an oil field provided that it bought all the natural gas in place and to be produced. It agreed to construct a plant and pipe lines, to separate out the heavier, saleable hydrocarbons (part of which would be turned over to the sellers as their share) and to return the lighter

hydrocarbons into the field to maintain pressure. The court concludes that because it owned the gas in place and because it made an investment in drilling, plants, lines, etc., of millions of dollars, it had an economic interest in the gas in place and was entitled to percentage depletion on 100% of its income from the sale of hydrocarbons. *La Gloria Oil and Gas Co.*, DC Tex., 12/19/57.

New breeding cattle rule applies only if held 12 months. For 1951 and later years, the Code includes in its definition of capital assets "livestock . . . held by the taxpayer for draft, breeding or dairy purposes and held by him for 12 months or more from the date of acquisition." In 1951 taxpayer sold some breeding cattle he had held for more than six but less than 12 months. He argued that the amendment of the Code was intended to apply to immature animals not actually used for breeding purposes for six months; they would be included as capital assets under the new 12-month rule, but that his particular situation was governed by case law [*Albright*, 173 F.2d 339, and *Bennett*, 186 F.2d 407] which gave capital asset treatment to mature animals actually used for breeding for six months. The Tax Court finds that neither the language of the Code nor its legislative history supports this argument; it holds the Code provided a new rule for all breeding cattle and under it capital gain is not allowable unless they have been held for 12 months. *McMurtry*, 29 TC No. 114.

Bank fails to meet requirements of special relief provision. In 1938 Congress passed a special relief provision designed to prevent the Government's collecting taxes at the expense of depositors whose claims had not been paid off during the depression. The statute provided that, where the depositors were given a lien on earnings or a preference against assets, no tax would be collected which would deplete the funds available for the payment of their claims. In 1933 taxpayer-bank gave its depositors deferred certificates for the amount of their deposits, payable out of future earnings and as the funds were released by the Illinois Auditor of Public Accounts. Since these certificates carried no lien, the requirements of the relief statute were not met. The district court also found that the payment of taxes in the year at issue would not deplete the fund for payment of the certificates. This court affirms. *DeKalb Trust & Savings Bank*, CA-7, 3/3/58.

Company "mining" oyster shells for others not entitled to depletion. A company which "mined" oyster shells for others by suction dredging under a year-to-year contract does not have an economic interest in the shells so as to entitle it to the 5% depletion allowance. *Matagorda Shell Co.*, 29 TC No. 111.

Transportation of oyster shells from dredge to shore included in depletion base. A company "mined" oyster shells by suction dredging them from the bottom of a bay. They were then washed, screened and sluiced through loading chutes onto barges, and transported to dock facilities along the shore over 50 miles away, where they were stockpiled. The company's sales to customers occurred at the dock sites where the shells were loaded for shipment. In determining the base for computing the 5% depletion allowance, the court holds the first commercially marketable mineral product was the stockpiled shells on the shore, and not, as the Commissioner contended, the shells on the dredge after they had been washed and screened. The fact that the company did not apply to the Commissioner for permission to include in income subject to depletion that portion of its gross receipts attributable to transporting the shells a distance greater than 50 miles (allowed by the Code if the Secretary finds it necessary) did not prevent the allowance of transportation for the first 50 miles allowed by the Code without permission. *Matagorda Shell Co.*, 29 TC No. 111.

Timber "cut" means inventoried. Section 117(k) gives an election to treat the cutting of timber as a sale (capital gain) in the year of cutting. The IRS rules that timber "cut" as is used in this section means timber the quantity of which has been inventoried, not the amount of timber actually cut in any tax year. This is because the ordinary practice of the timber industry is not to make any count or inspection of the timber until some time after it has been cut and has been hauled to the log landing. *Rev. Rul.* 58-135.

Ordinary income on "sale" of production payments. All of these cases involve the transfer by taxpayer for an immediate cash payment of a carved-out production payment in either oil or sulphur deposits until a specific sum of money had been realized by the transferee. Taxpayers claimed the gain was capital. The Tax Court and the Fifth Circuit held for the taxpayer; this Court reverses. The transfers are merely an assignment of future income. That the transactions are in the form of a sale of a real property interest under state law does not control the Federal tax consequences. [An analysis of the effect of this Supreme Court decision will appear in our July issue.—*Ed.*] *Fleming; Weed; Wrather; O'Connor; P. G. Lake, Inc.*, Sup. Ct., 4/14/58.

Roofing shingles are first commercially marketable product of slate quarry. Taxpayer's slate quarry produces slate for roofing shingles. Because of the hardness of the seam and other factors, taxpayer's quarry is different from others in the U. S. and more involved mining and production processes are necessary. Considering these facts, the court concludes that these processes are the ordinary treatment processes for this quarry, and depletion is computed on the selling price of the roofing shingles as the first commercially marketable product. *Arvonia-Buckingham Slate Co.*, DC Va., 3/26/58.

First commercially marketable product of magnesite mine determined. Taxpayer was engaged in the mining of magnesite. The Commissioner contended 10% percentage depletion should be computed on the value of crushed magnesite after concentrating processes. The court, however, upholds taxpayer's contention that the first commercially marketable product is grain magnesite produced after further firing and grinding. Depletion is computed on the selling price of this product, f.o.b. plant. *Northwest Magnesite Co.*, DC Wash., 3/6/58.

No depletion on cancellable contracts of strip miner. The district court found that taxpayer was not entitled to depletion on sales under contracts which gave the land-owner the right to terminate taxpayer's contract upon 30 days' notice, gave taxpayer the right to a fixed-price portion, and provided that title to the coal remained in the land. Under these contracts, taxpayer was in effect paid for services and has no depletable interest. Since this holding finds substantial support in the evidence, it is affirmed. *Huss*, CA-3, 3/27/58.

TAX STRATEGY NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B. CPA

Now only regional counsel need approve Tax Court Settlements

THE SETTLEMENT procedure of cases docketed in the Tax Court is expected to be facilitated by the decision of the Commissioner that full responsibility to approve settlements will be given to the Regional Counsel of the IRS on and after the opening day of the session of the Tax Court at which the case is calendered. The old rule (and the one still in effect for cases not yet scheduled for trial) was that approval of the Regional Appellate Division was also required.

The question whether the requirement for the concurrence of the Appellate Division was desirable has been studied from time to time—one of the most recent surveys, that of the Practitioners Advisory Group to the Mills subcommittee, took no position. It said it saw advantages and disadvantages in the rule and merely urged further study.

IRS audited 10% more returns last year

THE COMMISSIONER reports for the year ended June 30, 1957, that the number of returns audited annually increased by 10% and that this increase was about the same for each of the various types of return. "There were," the Commissioner said, "2,622,000 returns examined by the district audit divisions in this fiscal year. This is an increase of 233,000, or 10% over the number of returns closed by examination of taxpayers' books and records in the preceding year. Improvements in auditing procedures and techniques and effective utilization of available manpower, as well as the reduction in the number of technical personnel assigned to the taxpayer assistance program, are responsible for the increase.

"Also considered by the audit divisions were some 1,747,000 returns which were scrutinized and closed without taxpayer contact. This was a reduction of 195,000 in the number of returns closed by this method in this year, indicating improved selection of returns. This is attributable, for the most part, to improvements in the classification program (selection of returns for examination) brought about by the establishment of the chief classifying officer position, and by information developed from continuing analysis of the results being obtained from audit programs." ☆

Bank not liable for paying refund checks drawn to non-existent taxpayers

A FRAUDULENT "taxpayer" worked out an elaborate scheme for obtaining "refunds" of income tax: he filed wholly fictitious tax returns for mythical persons, attaching to each a W-2 he had prepared for non-existent employers and showing in each a refund of tax due. When the refund checks came through, he endorsed the fictitious taxpayer's name and usually some other equally fictitious endorsements and deposited them in various bank accounts he had established. The banks, of course, put the checks through for collection, the Government's account was charged and the "taxpayer" drew the proceeds from his various bank accounts. The Government sued the banks and, of course, the bank's liability depended on the law of negotiable instruments. It is well settled that a forgery does not pass good title, so that, if the payee forged the name of the taxpayer, then all holders' endorsements had no legal effect. The Fifth Circuit decided that there was no forgery so the Government could not recover; the endorser was the person, the "impostor," to whom the check was drawn. The case was *Atlantic National Bank* (12/10/57) reported by *Banking* as follows:

"The court prefaced its remarks with this observation: 'We think it plain that this is the classic case of an impostor.'

"In denying recovery, the court applied the impostor rule and held that, when the issuer of a check intends that it shall go to the person falsely pretending to be another, in fact non-existent, the endorsement by the impostor of the non-existent payee's name is not a forgery and his endorsement passes good title to the instrument.

"It made no difference, said the court, that dealings between the payee and the Treasury disbursing officer had not been carried out face-to-face.

"The person intended to receive the checks was the endorser who had submitted the returns, not the fictitious payees. He was the intended payee although they had been procured by his fraudulent representation." ☆

Number of tax returns examined
(Figures in thousands)

Type of return	*Fiscal year— 1957*	*1956*
Grand total	2,622	2,389
Income and profits tax, total	2,310	2,117
Corporation	170	166
Individual and fiduciary	2,140	1,951
Estate and gift tax	28	27
Excise and employment tax[1]	284	245

[1] Excludes examinations resulting in no tax change where such examination was made from the taxpayer's copies of returns in the course of an audit covering both income and excise and/or employment tax. The number of such "no change" returns thus excluded is 941,000 for fiscal year 1957 and 964,000 for 1956.

New decisions

"Amendment" to refund claim raised new issue; was new claim and untimely. The Commissioner asserted that taxpayer's 1954 partnership income was really taxable to a corporation. If the Commissioner could succeed, taxpayer would be entitled to a refund; he therefore filed a timely protective claim. After the time for filing had expired, he "amended" that claim by requesting refund of additional tax he had paid when the Commissioner included his wife's partnership income on his return. The court held the validity of the wife's status as a partner was a new issue and could not be added to the previous claim by amendment. It was a new claim. The district court dismissed the new claim as untimely. This court affirms. *Scharp*, CA-9, 12/13/57.

Tax Court has jurisdiction of hobby loss deficiency assessed under special time extension. The Commissioner assessed deficiencies against taxpayer under 1939 Code section 130 (which limits the deduction for hobby losses); these assessments were timely under the special one-

year extension granted under that section, though not under the ordinary rule. Taxpayer filed a petition to the Tax Court which, the Commissioner argued, should be dismissed because the Code does not give the court jurisdiction over assessments made under this extended time. The court holds there is no statutory authority warranting separate procedures for assessment and review of deficiency determinations under Section 130; it has jurisdiction over a deficiency properly assessed under Section 130. One dissent on the ground that the language of the Code strictly read does not support this interpretation. *Davis,* 29 TC No. 95.

Fraud penalties incurred at assessment. Taxpayer had filed fraudulent returns for two years; later he filed amended returns which overstated income and a refund of the over-assessment is concededly due. However, fraud penalties were asserted for these years and the Commissioner refused to allow interest on the overassessment, arguing that interest is payable only if the taxpayer is not otherwise indebted and that the fraud penalties should be treated as due from the time the fraudulent return was filed. The court holds that fraud penalties are not incurred until assessed and that interest is payable on the overassessment from payment of the tax until assessment of the fraud penalties. This is in accord with its decision in *Moore Shipbuilding* (72 Ct. Cls. 392) which it says is applicable even though the *Moore* case involved over-assessments and fraud penalties for different years. *Mason,* Ct. Cls., 4/2/58.

Filing form 870-TS does not bar subsequent refund claim. Taxpayer signed a waiver form 870-TS agreeing to a deficiency assessment and agreeing not to file refund claims. Then, after the three-year period of limitations expired within which the Commissioner could make further assessments, taxpayer claimed an overpayment for the same year. The Commissioner, while admitting that taxpayer's undertaking not to file a refund claim was not legally binding, since it was not a formal statutory closing agreement, contended that taxpayer should be equitably estopped from asserting his claim. The court finds the claim for overpayment related to a matter never considered in negotiations leading to the execution of form 870–TS, and since the Commissioner failed to show any detriment by reason of reliance thereon, taxpayer is not barred from now asserting the claim. One dissent on the ground that it has been held in other cases that mere showing of failure to assess deficiencies proves reliance by the Commissioner and supports estoppel without proof of the amount of possible deficiencies foregone. *Davis,* 29 TC No. 95.

"Totten trust" beneficiaries liable as transferees. Taxpayer established bank accounts in his own name in trust for various beneficiaries. At his death the passbooks were held by two of the beneficiaries, but merely, the court finds, for safekeeping. Thus under N. Y. law the transfers were still revocable. Since taxpayer was insolvent at death when the bank accounts were transferred, the beneficiaries are liable as transferees. *Est. of Schneider,* 29 TC No. 100.

Tax Court petition properly brought in new corporate name. The Tax Court holds that taxpayer corporation, after an official change in name, could properly file a petition in its new name even though the statutory notice of deficiency was made out in the original name. Furthermore, the fact that the corporation was dissolved at the time of the suit did not prevent it under applicable state law from prosecuting its claim in its corporate name within two years of its dissolution. *Jerry Anderson, Inc.,* 29 TC No. 102.

Assessment on ambiguous return upheld despite lack of 90-day letter. The excess profits tax returns filed by taxpayer for the years 1942-1945 were mere skeletons giving only its name and address and stating that it regarded itself as exempt because of its connection with foreign trade. In 1945, being concerned whether these were statutory returns, it filed amended ones, complete down to computation of tax, and repeated its explanation of why it made no payment. The Commissioner entered the amount of tax as an assessment and did collect it, but never issued a deficiency notice—the 90-day letter which permits petition to the Tax Court. Taxpayer now sues for refund on the ground that, because of the lack of the deficiency notice, no statutory assessment was made (and cannot now be made because of the expiration of the time within which the Commissioner can assess tax). Taxpayer points out that the Code specifically authorizes refund of taxes paid without a valid assessment. Commenting that it does not understand why the Commissioner failed to issue a 90-day letter, the court concludes that, given the ambiguous amended return, the attempted assessment was not a nullity. Filing a complete return is a self-assessment and, if payment is not attached, the IRS proceeds to collection without assessment. On the other hand, if the IRS treated taxpayer's return as no return, taxpayer would be subject to penalty for failure to file. Nor is the court persuaded by taxpayer's argument that failure to issue the deficiency notice denied it the right to go to the Tax Court and litigate its exemption without paying tax. It is well settled taxpayer could have obtained an injunction against collection of tax until the 90-day letter was issued. Finally, the court notes that the Code, in allowing refund where there was no statutory assessment, is more favorable to the taxpayer than the usual equity rule that refund is allowable only if the tax is in fact overpaid. The courts, therefore, should interpret this provision quite narrowly. Two judges dissent—the deficiency notice is a statutory requirement; the court has no discretion to waive it. Further, the right to enjoin an invalid assessment doesn't make it valid. *Lyddon & Co.,* Ct. Cls., 3/5/58.

Service won't disclose information on child support. The service may not disclose information furnished it by the taxpayer's former spouse relative to amounts expended for the support of their child *Rev. Rul.* 58-120.

Government's failure to send deficiency notice bars its suit. Taxpayer filed his income tax return for 1944 and received a refund of over $3,000. Two years later the Government decided that the refund was incorrect and sent a notice of proposed deficiency. The taxpayer properly protested the letter. The Government assessed the tax and sues to collect it, but never sent a deficiency notice. The court dismisses the Government's case on the ground that, without a deficiency notice, there can be no valid assessment and that the statute of limitations has run on the erroneous refund. *Williams,* DC N. Y., 1/6/58.

Taxpayer unsuccessful in trying his own case. The Commissioner had determined that taxpayer received certain unreported business income and that no

valid partnership existed between him, his wife and son, and disallowed certain deductions. Taxpayer was advised numerous times by the court to engage counsel to present his case and at least two continuances were granted for that purpose. However, he appeared without counsel at the trial. The court holds he failed to introduce any evidence with which to overcome the presumption of correctness of the Commissioner's determinations and rules against him. *Engel,* TCM 1958-52.

Tax Court has no jurisdiction over petition not signed by authorized agent. The Tax Court holds that it has no jurisdiction over a petition filed by a father in the name of his mentally incompetent son; no legal guardian had been appointed for the son, and no power of attorney had been filed with the court. *Engel,* TCM 1958-52.

Extension of time for nominee stockholders of investment companies. For 1957 and later years, regulated investment companies are permitted to designate undistributed capital gains to be treated as distributed. They pay the tax on the gain and the shareholder is permitted to treat that tax payment as made by him and to increase his basis as though he had reinvested the 75% of the gain. If stock in such companies is held in the name of a mere nominee, the nominee is required to give notice on Form 2439. To aid those nominees who are having difficulty in locating the beneficial owners, the IRS grants an extension of time for filing the form until 90 days after the close of the taxable year of the regulated investment company in the case of domestic nominees, and 120 days for foreign nominees. *News Release,* IR-215.

Agreement not a statutory closing; but equity bars refund [*Certiorari denied*]. The district court directed a verdict for the Government in taxpayer's refund suit. The taxpayer had agreed, in settlement for a tax year, not to sue for refund, signing form 870-AD. The agreement is not binding, because it was not the closing agreement signed by the Secretary, the only statutory way to close a year. However, the district court held that equity bars a refund. The Commissioner relied on that agreement and forebore additional tax and negligence penalties he had once asserted. It would be unfair to permit taxpayer to sue now that Commissioner's time for assessment had passed. The Fifth Circuit affirmed, with one dissent. *Daugette, cert. den.,* Sup. Ct., 3/10/58.

Information returns required for co-ownership electing non-partnership status. An organization which elects not to be treated as a partnership is required as a condition of the election to file a partnership return for the first excluded year and information returns for subsequent years. These are Form 1096 for the organization and Form 1099 for each individual who is a member, showing the kind and amount of income paid. The IRS rules that literal compliance is not necessary when there are large numbers of co-owners. The company involved here operated some 60 co-ownerships of oil and gas properties, each having an average of 75 co-owners with many being members of more than one organization. Under these circumstances filing one 1099 for each individual member is adequate if a list is attached showing the various organizations of which he is a member and the income from each. *Rev. Rul.* 58-132.

Trust for children liable for donor's income tax assessment. While there was an outstanding assessment against him, taxpayer transferred to his wife and attorney, as trustees for his children, securities worth more than the outstanding assessment. The court holds that the securitites transferred are a trust fund for the payment of taxes. *Helfenbein,* DC Ill., 1/31/58.

State tax-return-secrecy statute shields Federal return. Webb was suing a propane gas company for damages caused by installing cylinders which leaked, caught fire and resulted in the destruction of his house. The gas company asked that the court require the plaintiff to produce his Federal income tax return. They wished to use it to find out whether a deduction for loss was claimed and so offset the damage. The court forbids inspection of Webb's income tax return. The state statute which provides for the secrecy of the state returns cannot be defeated by requiring production of the Federal return with substantially the same information. *Webb,* Sup. Ct. Calif., 12/27/57.

Prior judgment on predecessor's closing inventory estops litigation on opening inventory [*Acquiescence*]. Taxpayer claimed on a consolidated return the loss of a subsidiary on inventory abandoned. The Commissioner contended that the value of the inventory at the beginning of the year was overstated. At the beginning of the year this particular subsidiary had been owned by another (unrelated) corporation and the value of its closing inventory had been litigated by its then parent with whom it had filed a consolidated return. The value upheld then was the figure used by taxpayer as the opening inventory in consolidation. The court holds that the judgment in that litigation estopped the Commissioner from litigating the content and basis of the opening inventory. Taxpayer, being a successor in interest, is held bound by the previous judgment and it follows that the Commissioner is also bound. *Seaboard Commercial Corp.,* 28 TC 1034, *acq.* IRB 1958-13.

Shareholder accepted partnership interest on dissolution; liable as transferee. Upon dissolution of a corporation in which she was stockholder, taxpayer received a 10% interest as a limited partner in a partnership to which the corporate assets were transferred. She never signed a partnership agreement, but consented to reporting her distributive share on her tax return. Although she never received a distribution of corporate assets directly, the court finds she ratified her status as a partner and is thus liable as transferee of the corporation to the extent of the value of her partnership interest. She also executed an IRS form admitting transferee liability, and the court holds this was done with knowledge of its legal effect. *Morse,* DC Calif., 2/17/58.

Assignment of contract income not prior to Federal tax lien. A subcontractor assigned all payments to become due under the contract to a surety as security for its undertakings under the bond. The assignment was made before notice of Federal tax liens was filed. The surety claims the assignment constituted a "mortgage," and as such entitled to priority over the Federal tax lien. In a brief per curiam decision, the Supreme Court holds the assignment as "inchoate and unperfected," and not entitled to priority. Four dissenting justices find the instrument constituted a mortgage under the law of Texas, and while state law is not necessarily controlling, it should be given great weight. *Ball Construction Co.,* Sup Ct., 3/3/58.

New excess profits tax decisions

EPT relief denied book cloth producer. A producer of book cloth which converted to the production of tent cloth for Government contracts during World War II is denied excess profits tax relief under Section 721(a)(2)(C) of the 1939 Code. The corporation failed to prove that its abnormally high income during taxable years 1942 through 1945 was attributable to its prewar research and development extending over a period of more than 12 months. *L. E. Carpenter & Co.*, 29 TC No. 63.

"New corporation" status available to newly organized subsidiary. A corporation organized after 7/1/45, which acquired all of its assets from a parent in business since 1925, cannot qualify for preferential tax treatment as a "new corporation" under the 1950 excess profits tax law. The Code clearly required that it must consider the time its parent was in existence in determining whether it was new. *General Retail Corporation*, 29 TC No. 69.

Duplication in base period combined earnings to be eliminated. For purposes of computing the credit under Part IV of the 1950 excess profits tax law, an "acquiring" corporation must eliminate a duplication of earnings in combining its base period net income with that of the purchased company. The regulation required the elimination of the purchased company's base earnings applicable when assets of the seller were used to acquire the new company. The court holds this elimination is proper even though the acquiring corporation has a negative base period net income. *Crater Lake Machinery Co.* 29 TC No. 67.

Customers' notes discounted not EPT borrowed capital. Because state law restricted the amount taxpayer could borrow from its bank by outright loans, it discounted installment notes receivable made by its customers. The court held that since taxpayer was only contingently liable on these notes, its liability arising only if the customer defaulted, they do not constitute borrowed capital for purposes of the Korean excess profits tax. The court also refused to allow relief for disruption of taxpayer's production during the base period by virtue of a strike in a supplier's plant and moving of its own plant. Taxpayer failed to produce evidence of a causal relationship between these events and a diminution of its operations. *Burford-Toothaker Tractor Co.*, DC Ala., 1/10/58.

Good will found to have been purchased; basis for EPT invested capital. In 1927, two national banks consolidated to form the taxpayer. Immediately, and as part of the same plan, the assets of a state bank were acquired. The shareholders of the state bank received stock of the consolidated bank having a value $500,000 greater than the tangible assets transferred. The taxpayer now contends this $500,000 represents purchased good will which has a basis for EPT invested capital purposes, while the Commissioner contends there was a nontaxable reorganization requiring a carryover of the transferor's zero basis. The transaction was considered a "purchase" in all of the documents of transfer. Only 81% of the state bank's assets was acquired by the taxpayer. From these facts, the court concludes that there was not a nontaxable reorganization and the good will has a basis of $500,000. *National Bank of Commerce*, DC Va., 2/4/58.

Royalty income from the mining of tungsten subject to EPT. Section 731 of the 1939 Code exempts income from the mining of tungsten and other strategic materials from the World War II excess profits tax. Taxpayer assigned mining properties containing tungsten in return for a 5% royalty on all tungsten extracted by the assignee. The Tax Court held that the royalty was not exempt from excess profits tax, as taxpayer was not engaged in the actual mining of the strategic material. This court affirms. *United Mercury Mines Co.*, CA-9, 2/3/58.

Can use base period of bank taken over by assuming its liabilities. The EPT regulations provided that a bank which purchased another could not add the base period earnings of the seller to its own to determine its earnings credits; that would be a duplication. However, if it increased its capital and used the increase to acquire another bank, it could add the seller's experience. In *Rev. Rul.* 56-163, the IRS had taken the position that acquisition of a bank for which the consideration was assumption of its deposit liabilities came under the first rule and did not increase the purchaser's credit. However, this issue was presented in *National Bank of Commerce of Seattle* and the Commissioner was overruled. In accordance with its acquiescence in that decision, the IRS revokes *Rev. Rul.* 56-163 and rules that the acquiring bank which assumes the seller's deposit liabilities may use the seller's base period experience. *Rev. Rul.* 58-42. Similarly *National Bank of Commerce of Seattle*, 27 TC 162, *acq.* IRB 1958-7.

PHC has no EPT credit carry forward to operating years. Taxpayer corporation was a personal holding company prior to 1943, when it became an operating company. The court holds that it is not entitled to any unused EPT credit from the period when it was a personal holding company and not subject to the excess profits tax. *Sunswick Corp.*, DC N. Y. 2/14/58.

EPT relief denied for failure to establish change in business. A cotton mill is denied excess profits tax relief under Section 722(b)(4), having failed to prove a change in the capacity for production after 1939 as a result of a course of action to which it was committed prior to 1940. While taxpayer showed that it had a plan to change production, it did not show that it had committed itself to this. *Royal Cotton Mill Co.*, 29 TC No. 84.

World War I EPT invested capital determined [*Acquiescence*]. Taxpayer was incorporated in 1889 and issued $300,000 of stock. The books of the corporation indicated that at least part of the stock was issued for the plant and goodwill of the predecessor partnership. Local incorporation law provided that stock was to be issued only for cash. Because the original incorporators were dead, there was no testimony. The Board holds for the taxpayer that the stock is to be valued at $300,000. *Washington Post Co.*, 10 BTA 132, *acq.* IRB 1958-11; *prior non-acq.* CB 1931 *withdrawn.*

Can't use base-period earnings prior to split-off of assets. During the base period taxpayer transferred part of its assets to a new subsidiary. The court

holds that, under these circumstances, it is denied the use of its own base-period experience; it must follow the rules for component corporations which, in effect, give the experience to the corporation with the assets. *Wood Mosaic Co.*, DC Ky., 2/20/58.

Deficiency asserted in answer in a Section 722 proceeding barred by limitations. A deficiency claimed by the Commissioner in an answer to a petition based upon a disallowance of a Section 722 claim is barred by the statute of limitations if it was barred when the notice of disallowance was mailed. *Central Paper Co., Inc.*, TCM 1958-48.

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CUMULATIVE INDEX TO CURRENT TAX LITERATUR

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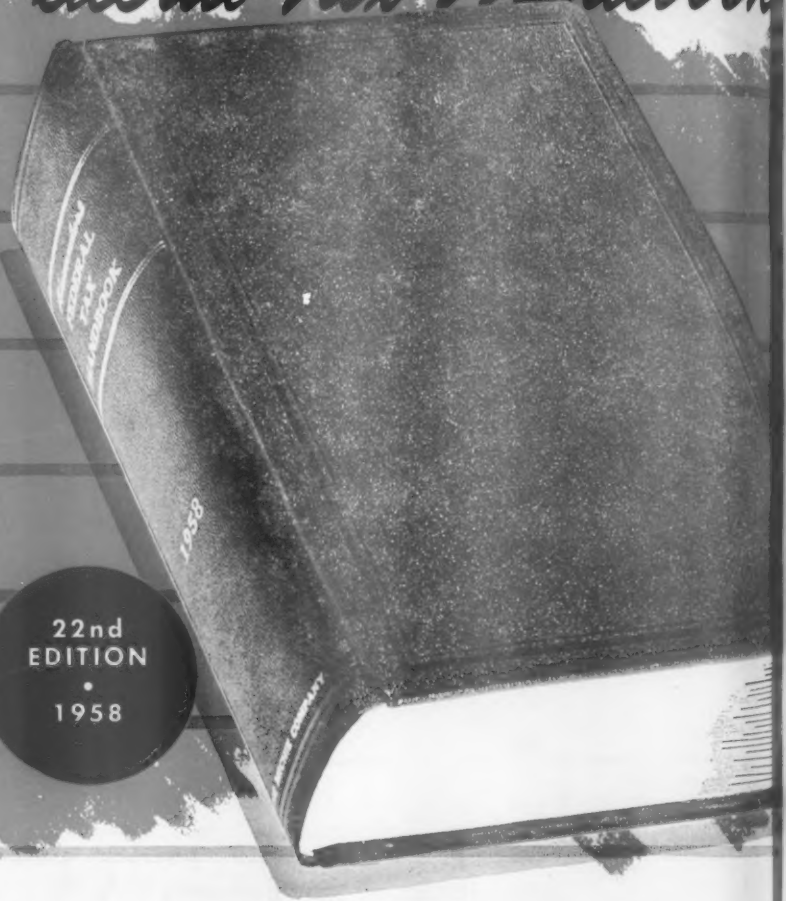

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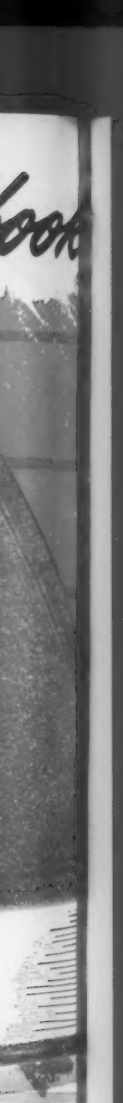

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